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Hungary: 2006 Article IV Consultation—Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2006 Article IV consultation with Hungary, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 6, 2006, with the officials of Hungary on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 24, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff supplement of October 4, 2006 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its October 11, 2006 discussion of the staff report that concluded the Article IV consultation.

The document listed below has been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

HUNGARY

Staff Report for the 2006 Article IV Consultation

Prepared by the Staff Representatives for
the 2006 Consultation with Hungary

Approved by Michael Deppler and Adnan Mazarei

July 24, 2006

Discussions for the 2006 Article IV consultation concluded in Budapest on June 6, 2006. The staff team comprised Mr. Mody (Head), Ms. Fabrizio, Messrs. Abiad and Mathibe (all EUR), Ms. Corbacho (FAD), Mr. Morris (ICM), and Messrs. Rosenberg and Sierhej (Regional Representative Office, Warsaw). Mr. Kiekens (Executive Director) and Mr. Abel (Advisor to the Executive Director) joined the discussions. The mission met with Prime Minister Gyurcsány, Finance Minister Veres, President Járai of the Magyar Nemzeti Bank (MNB), other senior officials, and representatives of the private sector and the academic community.

The new government's policies and market sentiment are likely to evolve, possibly rapidly. Following its reelection in April, the Socialist Party-led coalition has sought public support for reducing the budget deficit. The authorities are expected to clarify and enlarge the scope of fiscal consolidation, leading up to the submission of their Convergence Programme to the European Commission on September 1. A staff supplement, if needed, will provide an update prior to the Board meeting.

The authorities released the mission's concluding statement and intend to publish this staff report. The staff report for the 2005 Article IV consultation was discussed by the Board on June 11, 2005. It was subsequently published as IMF Country Report No. 05/213.

Hungary has accepted the obligations of Article VIII and maintains an exchange system free of restrictions on payments and transfers for current international transactions. In accordance with UN Security Council resolutions, Hungary maintains restrictions on, and imposes sanctions against, individuals, groups, and organizations associated with terrorism. Hungary subscribes to the Fund's Special Data Dissemination Standard. Data provision is, in general, timely and facilitates effective surveillance.

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EXECUTIVE SUMMARY

Despite its many strengths, Hungary faces important challenges. Following robust performance between 1997 and 2001, Hungary's growth has recently been respectable but at the low end among the New Member States of the European Union. It is projected, moreover, to trail regional peers in the coming years. Also, the ratio of employment to working-age population remains low. Of immediate concern are vulnerabilities caused by rising public and external debt ratios and the growing currency mismatches. Financial markets have sounded their warning signals.

Central to Hungary's economic outlook is progress in containing its runaway budget deficit. The new government's consolidation program is ambitious in intent and speed. While the proposed package contains some measures that take the long view, tax increases may not deliver the anticipated revenues and undermine growth and competitiveness. If market sentiment weakens, serious consequences could follow.

Action on several fronts is required to place public finances on a sound footing. A fiscal consolidation matching the intent of the authorities' program but extended over another two years would reverse the trend increase in the public debt-to-GDP ratio and bring it below the Maastricht limit by 2010, allowing euro entry from a position of strength. A focus on expenditure reforms and revenue enhancement by broadening the tax base will achieve sustainable consolidation. The endemic overruns in the budget deficit must be stemmed, through stronger controls, and greater transparency and accountability.

While interest rate policy is on a sound course, **the forint should float.** The recent increase of the policy rate by 25 basis points and the signal of a measured tightening cycle are appropriate in light of the risks to inflation. Because the exchange rate band is wide, it does not presently pose a constraint to the pursuit of inflation targeting. However, with euro adoption some distance away and the band serving no useful purpose, a risk-management perspective suggests that a floating exchange rate regime should be adopted.

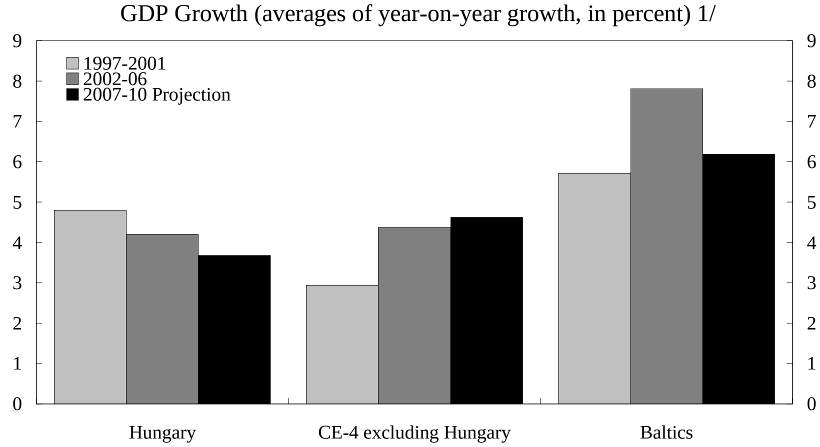
The banking sector has valuable safeguards, but recent trends call for more proactive supervision and regulation. The profitability and capitalization of the banking system remain robust. However, the increase in foreign currency lending and signs of worsening credit quality are causes for concern. Supervision will be strengthened by regular stress tests of individual banks and more intensive on-site assessment of risk-management practices. A requirement of higher provisioning against foreign-currency loans should also be considered.

Needed reforms to increase employment and enhance competitiveness are linked to structural fiscal measures. A smaller tax wedge and more effectively targeted social welfare programs (especially the disability pension and early retirement programs) will help raise the low employment rate. While the trade-weighted exchange rate is not obviously overvalued, a broader perspective highlights that productivity enhancement will be crucial for maintaining competitiveness. Ensuring that the EU funds are effectively used to raise productivity will require linking their deployment to fiscal structural reforms.

I. BACKGROUND

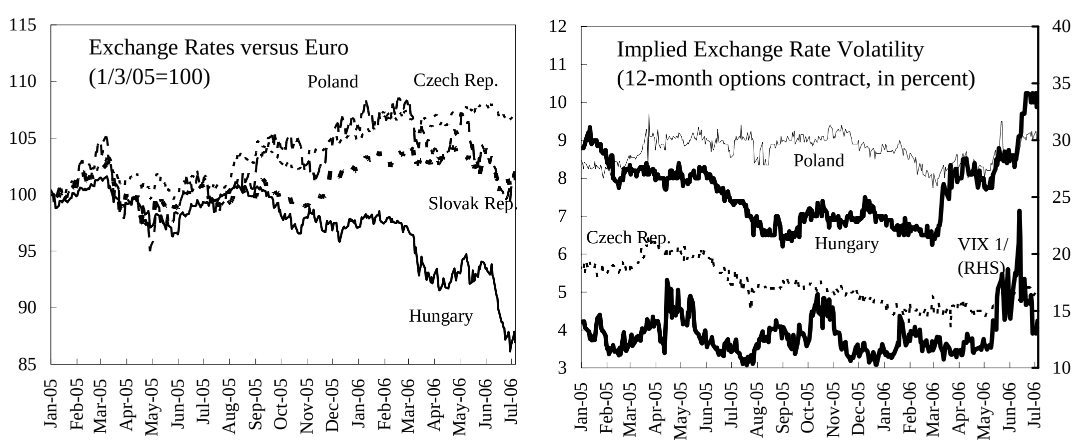
1. **Hungary's growth potential may be eroding, and vulnerabilities are making markets impatient.** While robust between 1997 and 2001, Hungary's GDP growth rate has recently been at the low end among the New Member States (NMS) of the European Union (EU), and projections push it further down in the rankings (Text Figure 1). Moreover, reflecting concerns about growing public and external debt, Hungary began to be differentiated by financial markets as early as September 2005 and has been further afflicted by the global increase in financial market volatility (Text Figure 2). For now, economic and financial buffers, assiduously built up over the last decade, offer some protection from a further slide in the currency and rise in interest rates. If these cushions wear thinner, and, especially, if global sentiment worsens, serious consequences cannot be ruled out.

Text Figure 1. Central and Eastern European Countries (CEECs): GDP Growth (averages of year-on-year growth, in percent) 1/



Sources: Eurostat; IMF, World Economic Outlook.
1/ The CEECs include the Central European-4 (CE-4) and Baltics. The CE-4 include Czech Republic, Hungary, Poland, and Slovak Republic. The Baltics include Estonia, Latvia, and Lithuania.

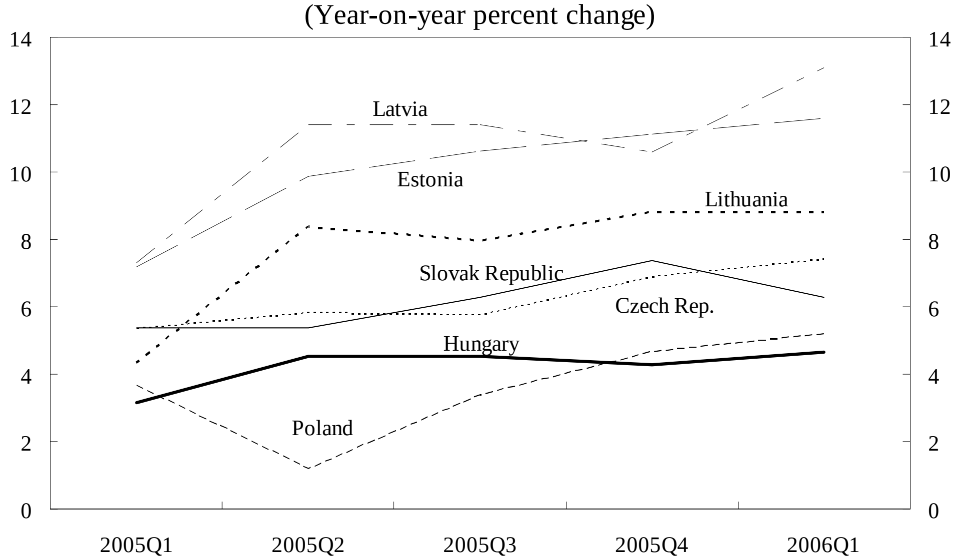
Text Figure 2. CE-4: Exchange Rate Movements and Volatility, 2005-06



Source: Bloomberg.
1/The Chicago Board Options Exchange SPX Volatility Index (VIX) reflects a market estimate of future volatility, based on the weighted average of the implied volatilities for a wide range of strikes. 1st & 2nd month expirations are used until 8 days from expiration, then the 2nd and 3rd are used.

2. **Since early 2005, growth has been respectable but disappointing in a regional perspective.** GDP growth slowed from 5.2 percent in 2004 to 4.1 percent in 2005 (Table 1)—the lower end of the economy's potential, which is estimated at 4-5 percent.[1] Hungary and Poland were the only two NMS whose growth decelerated in 2005. However, while the Polish economy picked up in the last quarter of 2005 along with stronger growth elsewhere, Hungary's economy continued to lag (Text Figure 3). Consumption growth moderated in 2005 with restrained wage growth and weak employment trends (Text Figures 4 and 5). Fixed investment growth largely reflected government-sponsored motorway construction. The strong contribution of net exports was likely exaggerated by the changed method for estimating imports; the unusually slow import growth was statistically balanced by a large drawdown of inventories.[2]

Text Figure 3. CEECs: GDP Growth, 2005-06
(Year-on-year percent change)

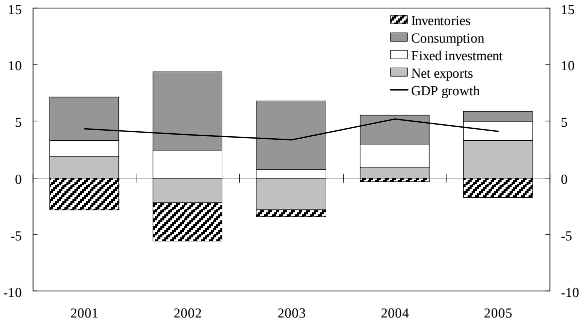


Source: IMF, World Economic Outlook.

[1] Schadler, Susan, and others, 2006, *Growth in the Central and Eastern European Countries of the European Union* (Occasional Paper 252, forthcoming). The growth rate in 2005 (and in the previous three years) benefited from an upward revision of about half a percentage point, following the European Commission's recommendation relating to "financial intermediary services indirectly measured."

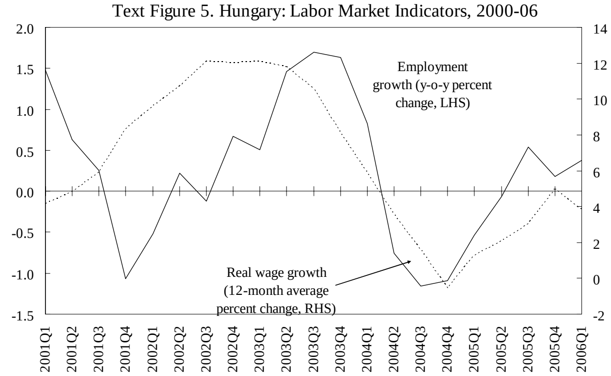
[2] Import growth is possibly underestimated because of a shift from border data collection (customs) to survey self-declaration, following EU accession in 2004.

Text Figure 4. Hungary: Contributions to GDP Growth, 2001-05
(Year-on-year, in percent)



Source: Hungarian Central Statistical Office.

Text Figure 5. Hungary: Labor Market Indicators, 2000-06

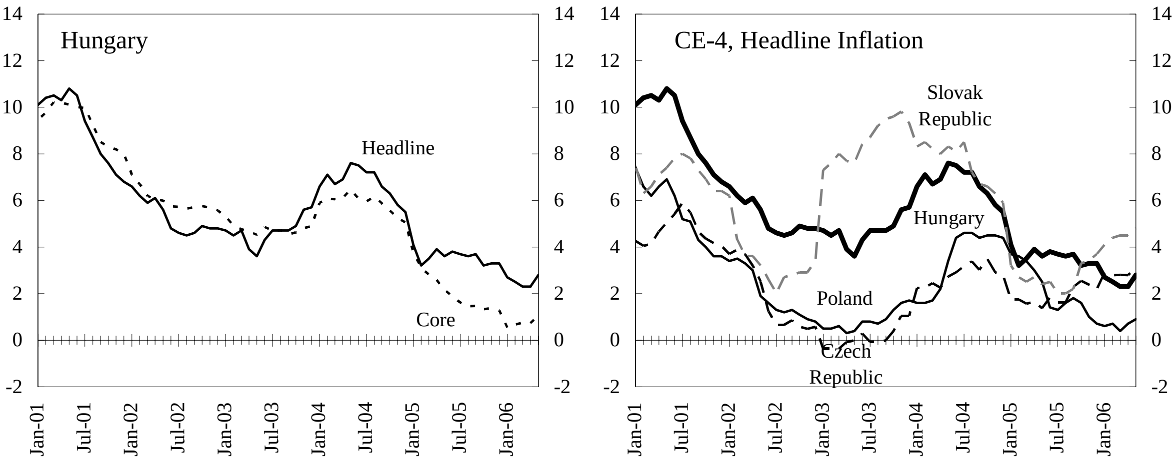


Source: Hungarian Central Statistical Office.

3. **Corporate performance indicators give mixed signals.** According to tax data, the average pretax return on corporate assets was about 5½ percent in 2004, in the same range as in recent years (Figure 1). In 2005, profitability was apparently maintained, with a continued decline in real unit labor costs, and optimism was reflected in the strong performance of the Hungarian equity market. However, profits have been unevenly distributed. While large firms and banks are typically highly profitable, about two-fifths of small and medium-sized enterprises (SMEs) are unprofitable. Moreover, since May this year, the stock market has experienced a significant correction. And, since mid-2005, Hungarian industrial production has not maintained its customary link with the improving German IFO index of business expectations.

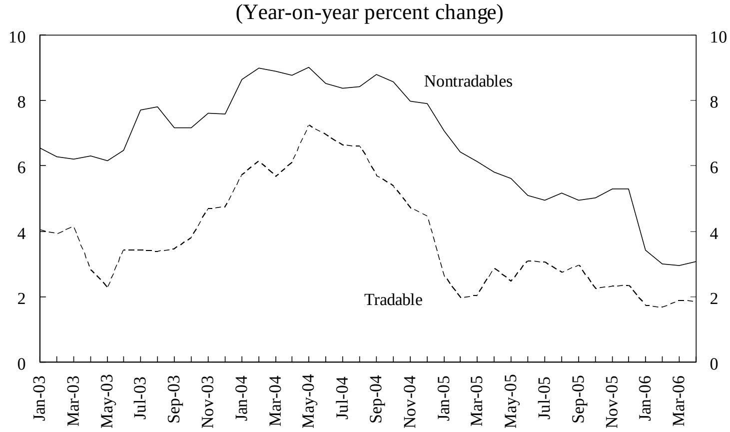
4. **Inflation has declined to historic lows, helped not only by one-off domestic factors, but also by globalization and declining inflation expectations.** Headline inflation (based on the consumer price index (CPI)) fell in May to 2.8 percent, year on year, and core inflation fell to 1.0 percent (Text Figure 6). Absent the cut in the value-added tax (VAT) rate in January 2006, year-on-year headline inflation would have been 4.5 percent, still within the ±1 percentage point band around the 3.5 percent end-2006 inflation target. The gap between headline and core inflation reflected rising energy and unprocessed food prices. Contributing to the containment of inflation was the global disinflation in traded goods (Text Figure 7). The VAT rate cut seems to have had a bigger effect on non-traded goods, which also benefited from a decline in inflation expectations.

Text Figure 6. CE-4: Inflation, 2001-06
(Year-on-year percent change)



Sources: Magyar National Bank; IMF, International Financial Statistics.

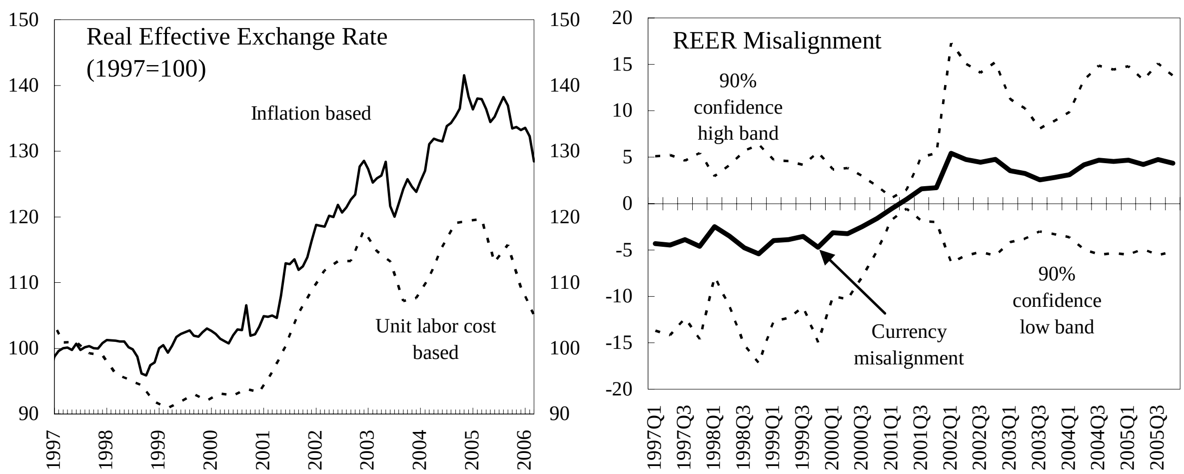
Text Figure 7. Hungary: Tradable and Nontradable Inflation, 2003-06
(Year-on-year percent change)



Sources: Eurostat; staff estimates.

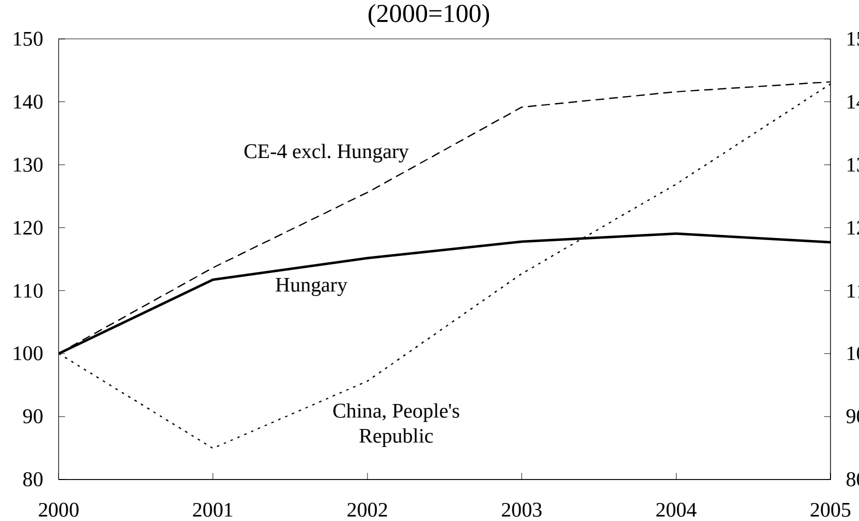
5. **The trade-weighted exchange rate appears to be close to its equilibrium value, but competitiveness concerns remain.** The CPI-based real exchange rate appreciated by 36 percent from 1997 to 2005 (Text Figure 8). Meanwhile, the real exchange rate became overvalued sometime around mid-2001, and by end-2005 was overvalued by about 5 percent, reflecting principally the accumulation of net external liabilities (in line with the MNB's estimates). Since the start of 2006, the exchange rate has depreciated significantly. This suggests no obvious overvaluation, for now. However, such an assessment is characterized by considerable uncertainty, and cautionary signs are also present. In particular, competitive pressures are being increasingly exerted by Asian economies, which are underrepresented in these trade-weighted measures; China, in particular, has rapidly expanded its share in the EU market, whereas Hungary's market share has plateaued (Text Figure 9).

Text Figure 8. Hungary: Indicators of Overvaluation, 1997-2006



Sources: Magyar National Bank; IMF, Information Notice System; and staff estimates.

Text Figure 9. CE-4: Market Share of EU Imports
(2000=100)



Source: IMF, Direction of Trade Statistics.

6. **The debt dynamics are worrisome.** Hungary now has the largest fiscal and current account deficits among sizable emerging markets (Text Table 1 and Table 4). In 2005, the fiscal deficit was 7.6 percent of GDP (Table 2).[3] The 2005 current account deficit, at 7.4 percent of GDP, showed some contraction relative to 2004 (Figure 2 and Table 3) but is

[3] Allowing for the exclusion of the cost of pension reform would lower the deficit by approximately 1½ percent of GDP.

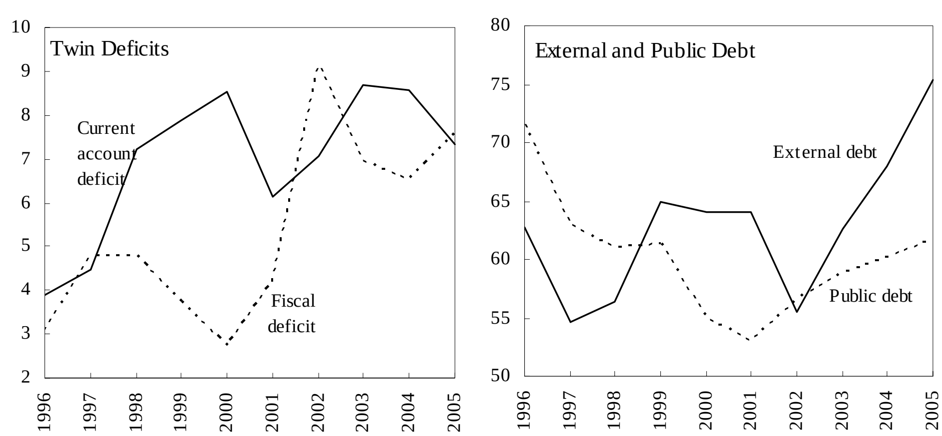
possibly underestimated by up to 2 percent of GDP, on account of the likely underreporting of imports, reflected in much larger errors and omissions. Both public and external debt ratios are rising and were at 62 and 75 percent of GDP, respectively, at end-2005 (Text Figure 10). If trends continue, the existing liquidity buffers could come under strain. Public debt has relatively long maturities and low foreign currency exposure, minimizing rollover risk and the costs of a large depreciation. The ratio of reserves to external short-term debt has remained at or above 100 percent. However, markets could destabilize debt structures or force involuntary contraction of the current account if debt trends are perceived to be unsustainable.

Text Table 1. Selected Emerging Markets: Public and External Deficits and Debts, 2005
(In percent of GDP)

	Fiscal Deficit	Public Debt	Current Account Deficit	External Debt
Hungary	**7.6**	**62.4**	**7.4**	**75.2**
Argentina	-2.5	85.9	-1.8	74.4
Brazil	3.3	75.1	-1.8	21.3
Poland	3.9	47.7	1.4	42.9
Turkey	3.1	67.9	6.3	49.5
Uruguay	0.8	69.9	2.0	68.4

Source: IMF, World Economic Outlook.

Text Figure 10. Hungary: Public and External Deficits and Debt, 1996-2005
(In percent of GDP)



Sources: Magyar National Bank; and Hungarian Ministry of Finance.

7. **For now, banks retain cushions against the rising risks from foreign currency lending to small businesses and households.** Reflecting low international interest rates and the relatively stable exchange rate in 2005, the foreign currency share of outstanding bank loans increased from about 43 percent in December 2004 to 53 percent in March 2006

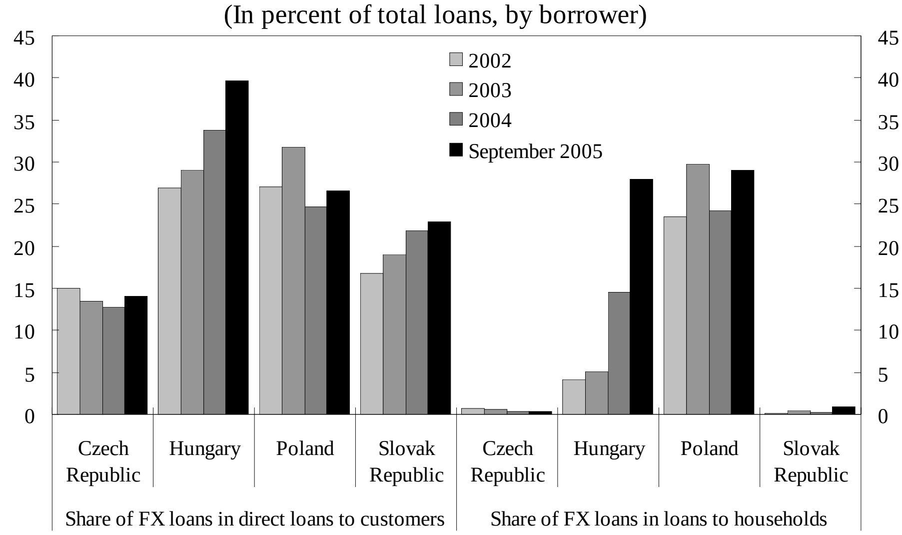
(Text Table 2). Households borrow in foreign currency directly from banks and indirectly via nonbank financial intermediaries (whose borrowings from banks are reported in the "other loans" category). Hungarian banks' exposure to foreign currency lending is now the highest of the four central European economies (Text Figure 11). Since banks are fully hedged against currency risk, they primarily face increasing credit risk—the possibility that borrowers may default if there is a large currency correction. While both the 2005 FSAP update and the authorities' April 2006 Financial Stability Report have tried to estimate the default risk, its magnitude is not known with any precision. On the favorable side, indebtedness levels are still low by western European standards. Moreover, the banking sector is at present able to withstand losses, as reflected in declining operating costs, strong profitability, and the system's capital adequacy ratio of around 11 percent (Figure 3 and Table 5). However, these buffers could prove inadequate for some banks if currency depreciation weakens borrowers and aggressive lending weakens banks.

Text Table 2. Hungary: Share of Foreign Currency Loans, 2002-06
(In percent of loans in category)

	2002	2003	2004	2005	Mar-06
All loans	**36.5**	**40.0**	**43.2**	**50.5**	**53.0**
Private sector	26.7	29.2	34.0	41.8	44.6
Nonfinancial companies	35.0	40.7	44.5	47.5	49.6
Households	3.0	5.0	14.6	32.6	36.9
Other loans	61.7	69.3	70.3	75.9	76.4

Source: Hungarian Financial Supervisory Authority.

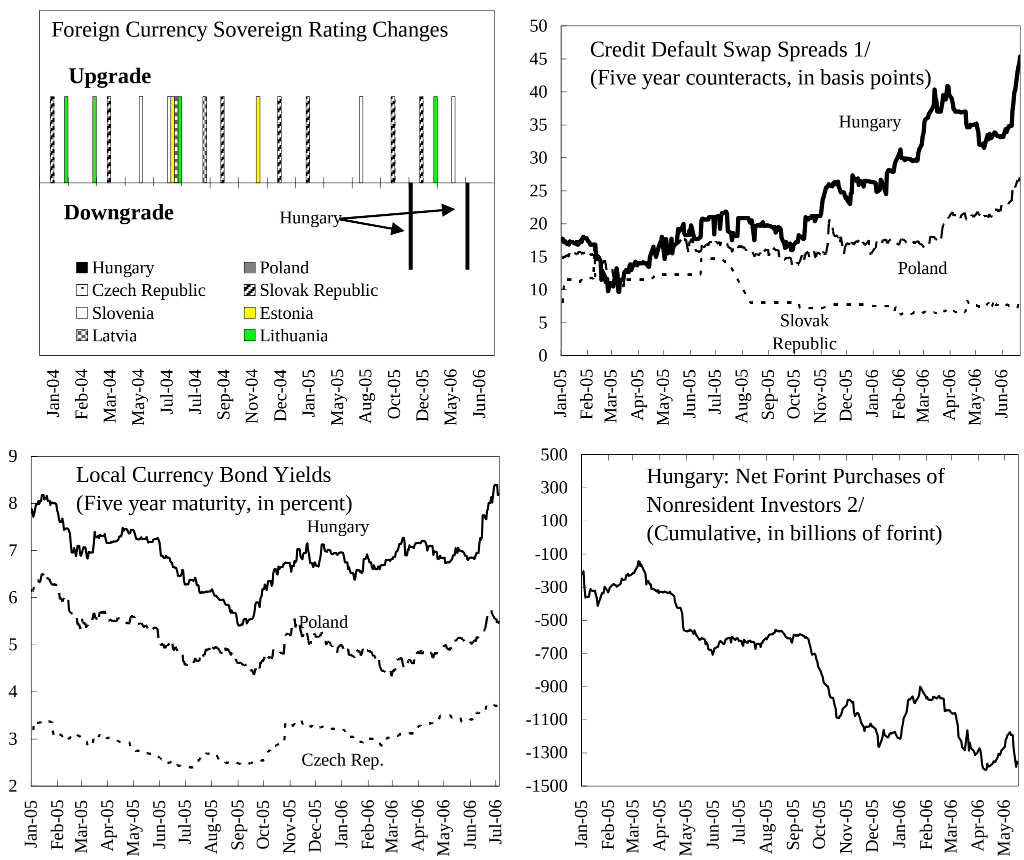
Text Figure 11. CE-4: Share of Foreign Currency Loans
(In percent of total loans, by borrower)



Source: Magyar National Bank.

8. **The rising debt levels and currency mismatches will have aggravated implications if financial markets continue to differentiate Hungary.** With "convergence play" and emerging market sentiment waning, domestic fundamentals have come under increased scrutiny (Box 1). Hungary's rating downgrades stand in contrast to the unchanged or improved ratings of the other CEECs (Text Figure 12). The differentiation has accentuated since March, with the unwinding of the so-called carry trade and the sharp correction in the Icelandic krona. The MNB estimates that portfolio investors have been withdrawing money from Hungary in large amounts. Commercial banks are, therefore, increasingly important suppliers of foreign currency financing through their lending, largely in Swiss francs, to domestic subsidiaries for on-lending to businesses and households. If these credit lines are not rolled over, the current account and output would contract.

Text Figure 12. CE-4: Differentiation by Financial Markets



Sources: Bloomberg; and Magyar National Bank.

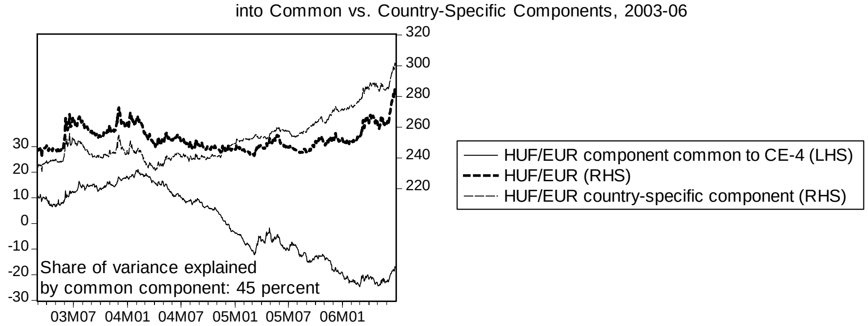
1/ The credit default swap (CDS) is an over-the-counter contract whereby the buyer pays the seller a periodic fee in return for a contingent payment by the seller upon default of the issuer of a credit instrument. Spreads are calculated versus the U.S.

2/ January 1, 2003 = 0. Cumulative, based on all daily FX transactions (spot, forward and options) as reported by credit institutions.

Box 1. Decomposing Exchange Rate Movements

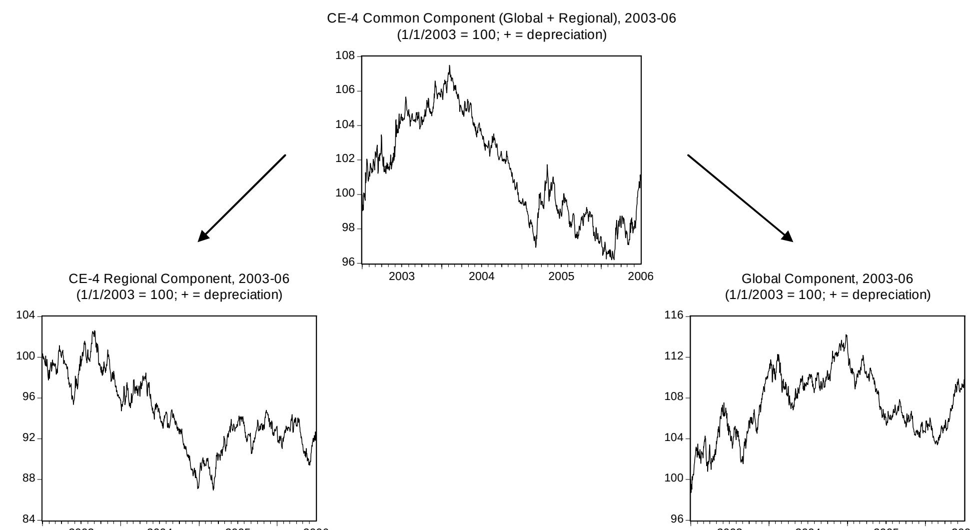
A common component explains a substantial portion of currency movements in the four central European (CE-4) currencies, which are analyzed in an accompanying selected issues chapter. However, the forint movements have been relatively independent, with the smallest share of the variance explained by the common component (Box Figure 1.1). While interest rate differentials vis-à-vis the euro area could potentially explain some of the country-specific currency movements, the weakening of the forint since end-September 2005 has not been related to the narrowing of interest rate differentials.

Box Figure 1.1. CE-4: Decomposition of Currency Movements into Common vs. Country-Specific Components, 2003-06



In turn, the CE-4 common component has had two parts. The “convergence play” related to EU accession and anticipation of euro zone entry held central European asset prices strong through late 2004. When that ended, asset prices remained supported in 2005 because of the positive sentiment toward emerging markets generally (Box Figure 1.2).

Box Figure 1.2. Decomposition of CE-4 Common Component into Regional and Global Components, 2003-06



These supporting forces have kept the forint from depreciating even further. With weakening emerging market sentiment, the forint is likely to be guided even more by domestic fundamentals.

II. Policy Discussions

9. **The state of public finances—epitomized by endemic deficit overshooting—is undermining growth prospects and economic stability.** By rapidly proposing sizable fiscal measures, the new government has acknowledged the urgency of containing the growing public debt. However, not least because the tax measures under consideration could hurt competitiveness and, hence, may require reversal, the present political window of opportunity should, staff urged, be used more aggressively to cut spending and implement budgetary controls (Box 2). In this context, the discussions also addressed the conduct of monetary policy, safeguards for the financial sector, and measures to improve labor absorption and strengthen competitiveness.

Box 2. Response to Fund Advice

The authorities have broadly concurred with Fund's policy advice, but have viewed necessary steps as less urgent. Moreover, fiscal consolidation has been constrained by domestic political considerations.

Fiscal policy. The authorities have relied principally on ad hoc measures to stabilize public finances. Limited effort has been directed toward expenditure reduction to achieve sustainable consolidation. The authorities' tax reform in 2005 was, in staff's view, not affordable without concomitant expenditure cuts. Staff's recommendations for enhanced fiscal transparency and credibility have not been taken on board.

Monetary policy. Since 2004, monetary policy has more closely hewn to its stated objective of inflation targeting, as recommended by the Fund. Policy credibility has also been helped by the MNB's more consistent and transparent communications strategy. Authorities have resisted the Fund's recommendation to move to a floating exchange rate regime.

Financial sector. The 2005 Financial Sector Assessment Program (FSAP) update reported significant advances in financial sector regulation and supervision. In line with the update's recommendations, the authorities have strengthened the bankruptcy regime and pension regulation, and raised consumer awareness of the risks inherent in foreign currency borrowing. Progress has been slower in evaluating credit risks from unhedged foreign currency borrowing.

A. Fiscal Consolidation Plans and Macroeconomic Outlook

10. **The authorities have announced a large fiscal adjustment program.** Absent new measures, the budget deficit in 2006 was projected at 11.1 percent of GDP (in ESA'95 terms, without the credit for the pension adjustment). The authorities' fiscal consolidation plan, to commence in the second half of 2006 and continue through 2008, is projected to achieve savings of over 10 percent of GDP, about three-fifths relying on higher taxes (Text Table 3). Since the measures include limiting the anticipated deterioration of the baseline (about 3 percent of GDP), and given known additional obligations, the cumulative deficit reduction would be about 7 percent of GDP. The authorities project in 2006, a deficit of 9.5 percent of GDP, going down sharply to 5 percent of GDP in 2007 and to around 3 percent of GDP in 2008.

Text Table 3. Hungary: Fiscal Stance Under Authorities' Strategy, 2006-08 1/
(In percent of GDP)

	2006		2007		2008		Cumulative 2006-2008	
	Authorities	Staff	Authorities	Staff	Authorities	Staff	Authorities	Staff
Baseline overall deficit (excluding additional pressures and proposed measures)	**6.4**	**6.4**	**9.5**	**10.1**	**5.0**	**7.6**		
Currently known additional pressures	**4.7**	**4.7**	**1.5**	**1.5**	**1.0**	**1.0**	**7.3**	**7.3**
Expenditure	4.4	4.4	0.2	0.2	-0.5	-0.5	4.1	4.1
Revenue (including 2005 tax reform)	0.3	0.3	1.3	1.3	1.5	1.5	3.1	3.1
Revised baseline overall deficit (including additional pressures, excluding measures)	**11.1**	**11.1**	**11.0**	**11.7**	**6.0**	**8.6**		
Total expected savings from proposed measures	**1.7**	**1.0**	**6.2**	**4.0**	**2.9**	**2.2**	**10.7**	**7.2**
Expenditure reforms	**0.9**	**0.7**	**2.1**	**1.4**	**1.1**	**0.5**	**4.2**	**2.6**
Public Administration (wage freeze, employment cuts, caps on operational spending)	0.3	0.3	0.9	0.5	0.3	0.1	1.5	0.9
Education (increase in number of hours by teachers)	0.0	0.0	0.1	0.0	0.0	0.0	0.1	0.0
Health Care (reform of pharmaceuticals and basic care)	0.3	0.1	0.5	0.3	0.6	0.3	1.4	0.7
Subsidies (gas, electricity, and transport)	0.3	0.3	0.6	0.6	0.2	0.1	1.2	1.0
Tax reforms (including impact of delaying pending items of 2005 tax reform)	**0.8**	**0.3**	**4.1**	**2.7**	**1.7**	**1.7**	**6.6**	**4.7**
Increase in VAT rate from 15 to 20 percent and excises	0.2	0.2	0.4	0.3	-0.1		0.5	0.5
Increase in health care and social security contributions	0.3	0.2	2.2	1.6		0.1	2.5	1.8
Solidarity tax, tax on small businesses, and other corporate taxes	0.3		1.1	0.6	0.1	0.1	1.5	0.7
Tax on interest income and capital gains	0.0		0.1	0.1	0.1	0.1	0.2	0.2
Tax on pensions under the personal income tax			0.1	0.1			0.1	0.1
Other			0.1	0.1	0.1		0.2	0.1
Maintain local business tax/strengthen real estate tax					1.5	1.5	1.5	1.5
Extra margin for slippages			0.2					
Overall projected deficit (including savings from proposed measures)	**9.5**	**10.1**	**5.0**	**7.6**	**3.1**	**6.4**		

Source: Staff estimates on the basis of the authorities' calculation of the specific measures in the new fiscal adjustment package.

1/ Includes the costs of pension reform and the aircraft lease in 2006 and 2007.

11. **While the authorities project painful short-term macroeconomic results, they anticipate medium-term gains.** After GDP growth of 4½ percent in 2006 (despite the continuing large fiscal stimulus of about 2½ percent of GDP), the authorities expect growth to fall to 2½ percent in 2007, but followed by rapid recovery thereafter. Staff expressed concern that expectations of a quick rebound may be overly optimistic since the new capital and labor taxes add to the already high tax rates and would reduce the incentives to work and invest, and hurt competitiveness. If the tax increases need to be undone, new solutions will be needed to stabilize public finances: policy variability can only hurt. The authorities project that the additional taxes and reduction in subsidies will raise inflation to about 6 percent in 2007, despite the anticipated slowdown in consumption, but expect the one-off effects to subside quickly. They see the principal gain of this strategy as reversing the recent trend rise in the public debt (however, they had not completed their estimates). Staff project a public debt-to-GDP ratio of about 68 percent of GDP by end-2006, and if the authorities' package is implemented fully, it will fall to 63 percent by 2010.[4]

12. **Staff took the view that the consolidation package would deliver less than what the authorities expect.** Given the likely political, legal, and administrative delays in the approval and implementation of the proposed measures, staff's estimate of the fiscal deficit

[4] These numbers do not include the debt of some heavily indebted public enterprises, publicly-guaranteed debt, and the obligations of recent public-private partnerships (PPPs).

in 2006 is 10 percent of GDP.[5] Staff projects the deficit to fall to only 7½ percent of GDP in 2007 and to 6½ percent in 2008 (see Text Table 3 and Table 6). Staff expects lower yields from solidarity taxes on personal and corporate income, health and social security contributions, and public administration and health reform.[6] In contrast, ad hoc measures to raise labor and capital taxes carry several risks.

13. **In staff's baseline scenario, premised on the smaller deficit reduction, short-term growth and inflation outcomes will be less painful but public debt will continue to rise.** GDP growth is likely to be 3½ percent in 2007 and remain below 4 percent through 2010 (Text Table 4), thus continuing to trail regional growth (see Text Figure 1). Growth will be dampened for the same reasons as in the authorities' scenario—reduced demand, weak incentives, and the risk of continued policy variability—but by a smaller extent than if the authorities' anticipated consolidation took place in full. Under staff's baseline, inflation could rise from 3½ percent in 2006 to about 5¾ percent in 2007. An upside risk to inflation arises from the possibility of a greater depreciation than currently envisioned. While concerns about second-round effects exist, staff agreed with the authorities that the risks are presently low, based on the experience with accession-related tax hikes of 2004 and with wages rising more slowly than productivity. Staff's principal concern is that public debt under the baseline will continue to rise, exceeding 70 percent of GDP by 2008 (Figure 4 and Table 7).

Text Table 4. Hungary: Staff's Baseline Scenario

	2006	2007	2008	2009	2010
			(In percent)		
Real GDP growth	4.5	3.5	3.7	3.7	3.8
Consumption	3.5	2.2	2.9	3.0	3.5
Investment	7.3	6.2	5.8	5.5	5.8
Exports	12.2	7.7	6.6	6.3	6.6
Imports	11.9	7.5	6.6	6.3	7.0
Inflation	3.5	5.8	4.4	3.5	3.0
			(In percent of GDP)		
Fiscal deficit	10.1	7.6	6.4	5.8	5.5
Primary deficit	6.2	3.7	2.5	2.1	1.9
Current account deficit	9.1	8.0	7.6	7.4	7.1
Public debt	67.8	69.5	70.6	71.6	72.5
External debt	81.8	82.2	82.5	83.2	84.0

[5] If some recent PPP investments are included, the deficit would be about 11 percent of GDP. The fiscal transparency ROSC in May 2006 concluded that the motorway investment spending through a PPP between the government and the state-owned motorway company AAK should be recorded on budget because the motorway ownership will remain with the government.

[6] The regional reform bill, necessary to significantly reduce public employment and the wage bill, was not approved by parliament in July.

14. **External vulnerabilities will also continue to increase.** The current account deficit could rise to about 9 percent of GDP this year (if the suspected underreporting is reversed) and decline gradually to about 7 percent of GDP by 2010. However, these projections will remain subject to uncertainty because of the changed approach to estimating imports. Importantly, staff cautioned that the external financing requirement (arising either from underrecorded imports or inflows recorded in errors and omissions) would remain high, and external debt would likely rise to about 82 percent of GDP by end-2006 and maintain an upward trajectory (Figure 5 and Table 8).

15. **During the currency's slide, sufficient confidence has ensured the necessary financing of the current account, and balance sheet effects have been minimal—but this cannot be presumed.** The authorities recognized that, if the political willingness to consolidate were to fade, a significant exchange rate correction could be accompanied by higher interest rates, reduced confidence, a retrenchment of consumption and investment, and a contraction of the current account. They acknowledged staff analysis, which shows that, although the likelihood of a sudden stop in capital inflows—or an involuntary contraction in the current account—is in the 3-5 percent range, this likelihood can quickly increase with trends in external debt servicing and an adverse turn in market sentiment.[7] Under currently plausible scenarios, the authorities viewed the risk of a balance-sheet-induced crisis to be low (Box 3). While staff agreed with that assessment, it cautioned that trends in the banking sector were a source of growing concern.

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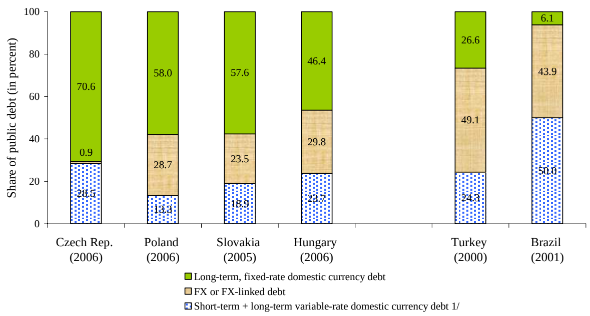
[7] Eichengreen B., P. Gupta, and A. Mody, 2006, "Sudden Stops and IMF-Supported Programs," IMF Working Paper 06/101.

Box 3. Perspectives on Balance Sheet Risks

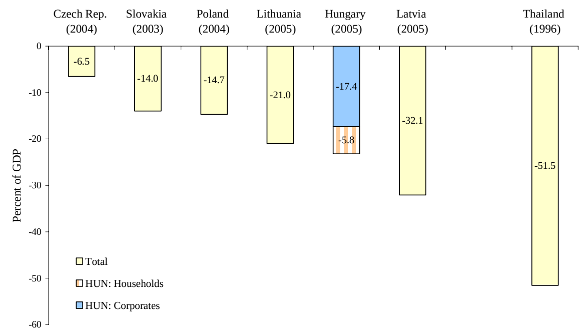
Public debt. Stress tests show that Hungarian public debt dynamics will be more seriously affected by a sharp rise in interest rates than by currency depreciation. With its gradual shift toward long-term, fixed-rate local currency borrowing, Hungary's public debt has considerably less exposure to currency and interest rate risks than in Turkey in 2000 and Brazil in 2001 in the run-up to their crises (Box Figure 3.1).

Box Figure 3.1. Public Debt Structure: CE-4, Turkey 2000, and Brazil 2001



1/ Includes CPI-indexed debt.

Box Figure 3.2. Net FX Position of the Private Non-Financial Sector: CECs and Thailand 1996 (in percent of GDP)



Source: Central banks; BIS; and staff estimates.

Private sector. The large Hungarian firms carry significant natural hedges. The MNB is concerned, however, that weak SMEs may not be able to withstand a sharp currency correction. Households have buffers in the form of substantial forint-denominated financial assets (Box Table 3.1). However, some households with large foreign currency liabilities may lack significant financial assets, though information on this score is fragmentary. Overall, the private sector exposure to currency risk is significantly less than in Thailand in 1996 (Box Figure 3.2).

Box Table 3.1. Hungary: Domestic Balance Sheet Indicators, 2005 1/

	Assets				Liabilities			
	Short-term	Long-term	Domestic currency	Foreign currency	Short-term	Long-term	Domestic currency	Foreign currency
	(In percent of Total liabilities)							
Public sector	16	18	9	25	29	71	74	26
Financial sector	33	73	72	34	63	37	70	30
Corporate sector	53	10	34	29	38	62	43	57
Household sector	151	70	208	13	16	84	65	35

1/ Figures exclude derivatives and equity capital
Sources: MNB, IMF Staff calculations

Banking sector. With banks' foreign currency assets and liabilities roughly matched, the banking sector is more susceptible to substantial increases in short-term interest rates (Box Table 3.2). The extent of credit risk from unhedged borrowers is uncertain, but a doubling of nonperforming loans will hurt some banks, affecting their capital. Systemically important banks are likely to remain protected by their existing cushions. However, the continued rise in foreign currency lending implies the need for a closer monitoring of such credit risks.

Box Table 3.2. Hungary: Summary Results of Banking Sector Stress Tests

Shock	Impact on Tier I Capital (In pecent of Tier I Capital)	Number of Banks Whose CAR Falls below 8 percent
Parallel upward shift in forint yield curve of 500bps	-5.6	2 out of 32
Depreciation of 40 percent	-2.6	0 out of 32
Increase in nonperforming assets of 100 percent	-15.2	9 out of 32
Scenario: 30 percent depreciation, upward shift in forint yield curve of 200bps, and a deterioration in 30 percent of unhedged foreign currency loans 1/	-14.5	7 out of 32

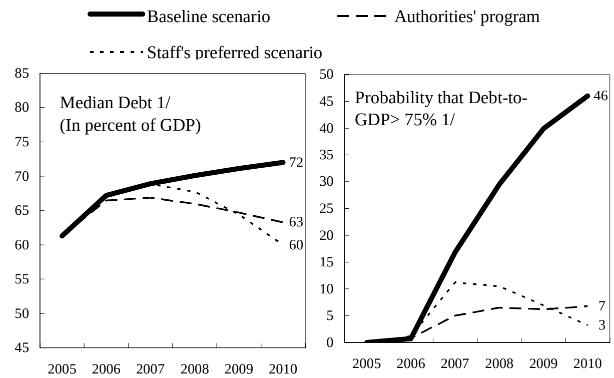
Source: Hungary Financial System Stability Assessment Update (Country Report No. 05/212).
1/ Loss given default is assumed to be 50 percent.

B. Toward Sustainable Public Finances

16. **A cumulative fiscal consolidation of 10 percent of GDP over 2006-10, based on a more far-reaching expenditure reduction than currently contemplated, would raise Hungary's growth potential.** This effort, comparable in magnitude in the early phase to that proposed by the authorities, stretches the consolidation to 2010. It would lower the debt-to-GDP ratio to below 60 percent (Text Figure 13). Recent research shows that the deficit and debt reduction complement each other to raise the growth potential.[8] In addition, staff's proposal is for a greater reliance on expenditure-based consolidation to reduce the large size of the government, which is not commensurate with Hungary's per capita income (Text Figure 14). The delivery of public services can be better targeted and the efficiency of social spending increased (Text Figure 15). A smaller, more efficient government will help immediate consolidation needs and raise growth potential (Box 4). These sound fundamentals will facilitate euro adoption and robust economic performance thereafter.[9] Staff's proposed package includes needed revenue enhancements through a broadening of the tax base, as discussed in the accompanying selected issues chapter.

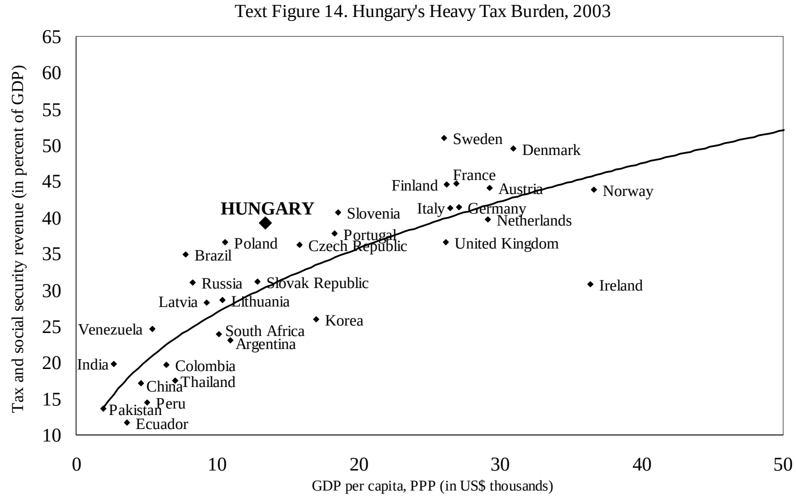
Text Figure 13. Hungary: Public Debt Dynamics, 2005-10
(Fan-chart approach)

	Primary Surplus (in percent of GDP)				
	2006	2007	2008	2009	2010
Baseline scenario	-6.2	-3.7	-2.5	-2.1	-1.9
Authorities' program	-5.6	-1.3	0.5	0.6	0.7
Staff's preferred scenario	-6.1	-2.6	0.7	2.4	3.9



Source: Staff estimates.
1/ Figures show the median debt and the probability of debt-to-GDP ratio exceeding 75 percent from 1,000 simulations.

Text Figure 14. Hungary's Heavy Tax Burden, 2003



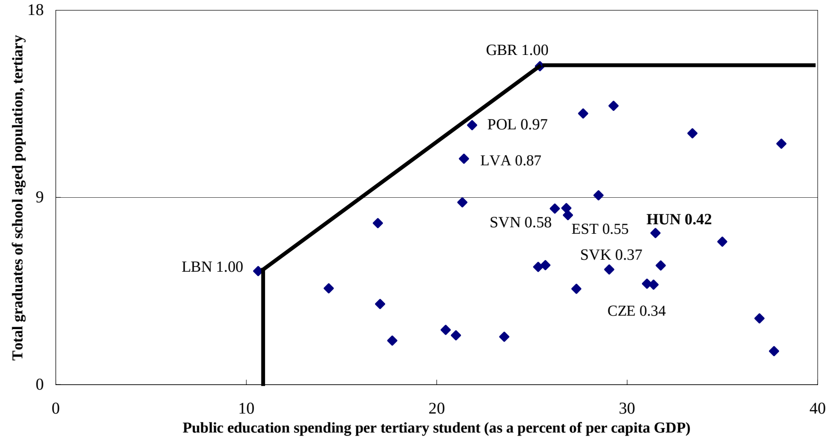
Sources: World Economic Outlook, OECD, World Development Indicators, Government Finance Statistics, and

[8] Adam, Christopher, and David Bevan, "Fiscal Deficits and Growth in Developing Countries," 2005, *Journal of Public Economics*, Vol. 89, (March), pp. 571-97.

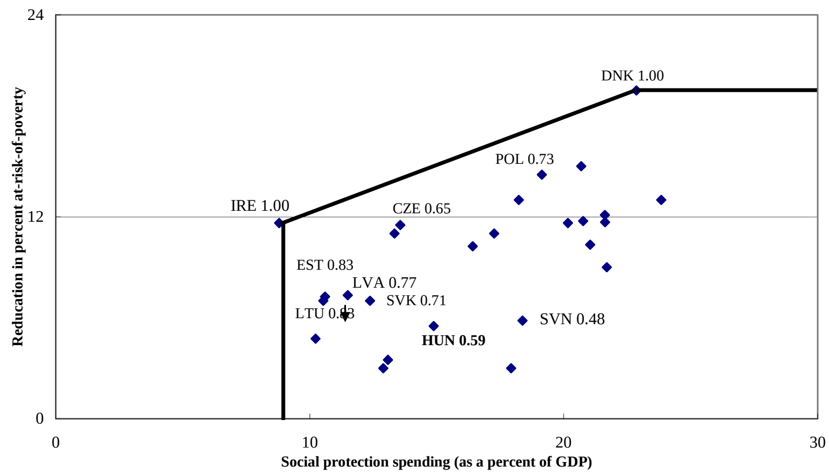
[9] Schadler and others, "Growth in the Central and Eastern European Countries."

Text Figure 15. Hungary: Efficiency of Public Spending

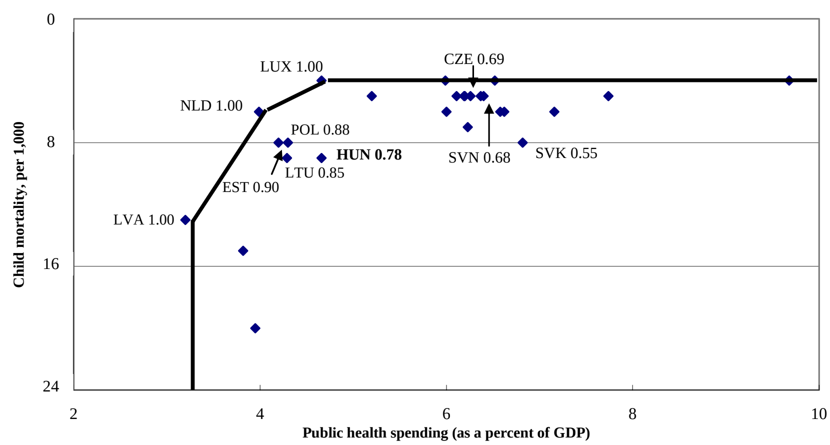
Efficiency of Public Spending in Increasing Graduates in Tertiary School



Efficiency of Public Spending in Reducing Population at Risk of Poverty



Efficiency of Public Spending in Reducing Child Mortality



Source: Mattina, T., and V. Gunnarson, 2006, "Budget Rigidity and Expenditure Efficiency in Slovenia," Slovenia Selected Issues.

Box 4. The Composition of Fiscal Adjustment and Economic Performance

Expenditure cuts have proved more sustainable than adjustments relying heavily on tax increases. IMF research[1] has shown that expenditure-based adjustments work particularly well when focused on the reduction of subsidies, wages, and transfers, supported by structural reforms. Revenue-based consolidations have often been reversed, except when they have emphasized broadening the tax base and strengthening tax administration. Particularly in countries with heavy tax burdens and weak revenue administrations, tax measures have been prone to evasion and a larger informal economy, weakening the sustainability of the adjustment. Following large, expenditure-based fiscal adjustments, GDP growth recovered to its trend during the first two years of the adjustment, driven by private investment and gains in consumption and trade balances.

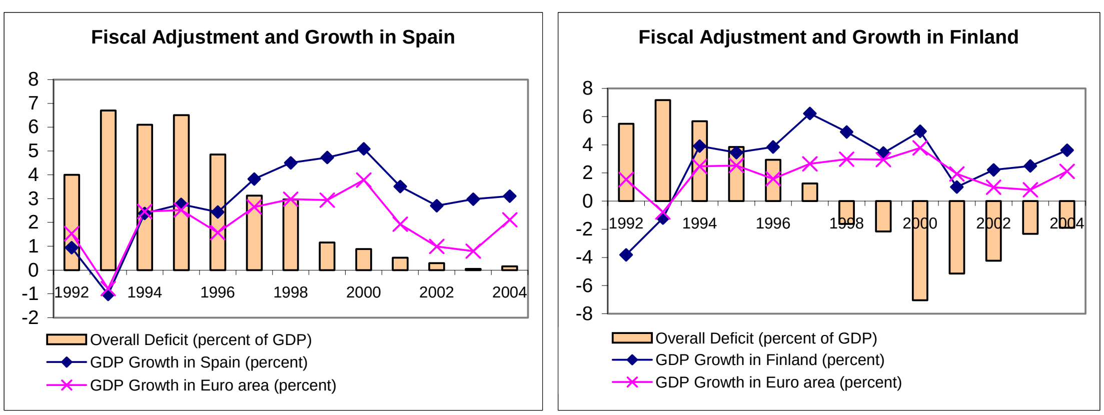
Expenditure-based consolidations are also supportive of growth, as the European experience confirms. Spain reduced primary spending by over 6½ percent of GDP during 1994–97, mainly through cuts in subsidies and transfers. Finland consolidated social security and welfare payments by 8 percent of GDP during the 1990s through reforms of the pension system and unemployment benefits. Following fiscal consolidation, growth in these countries outpaced their own average prior to fiscal consolidation, while exhibiting less variability (Box Table 4.1 and Box Figure 4.1).

Box Table 4.1. Growth Performance in Spain and Finland

	1980-1993	1994-2004
Spain		
Growth	2.5	3.7
Std. Dev.	2.0	1.0
Finland		
Growth	1.5	3.6
Std. Dev.	3.4	1.4

Source: Eurostat; and staff estimates.

Box Figure 4.1. Fiscal Adjustment and Growth in Spain and Finland



Source: AMECO; and staff estimates.

1/ Tsibouris, George C., and others, 2006, "Experience with Large Fiscal Adjustments," IMF Occasional Paper No. 246.

17. **The authorities' expenditure reduction measures are welcome, but staff underscored the urgency of bolder efforts.** The steps under consideration in such areas as public administration, government employment, health, education, and subsidies go in the right direction, and the task is to rapidly establish supporting legislation and administrative procedures, including for individual health accounts. The authorities acknowledged that the fiscal implications of an aging population needed early attention. In this context, staff recommended indexing pension benefits to inflation; gradually increasing the retirement age; eliminating the thirteenth-month pension for new retirees; introducing more stringent rules for the disability pension; and phasing out early retirement schemes (Text Table 5). Staff also argued for reforming the welfare system, redirecting budget support to families to the poor, and eliminating the house subsidy scheme. These steps would help restore public finances and increase households' incentives to save. The authorities agreed with the thrust of staff's suggestions but viewed these as medium-term objectives.

Text Table 5. Hungary: Menu of Reform Options
and Estimates of Their Potential Budgetary Savings in 2006-10
(In percent of GDP)

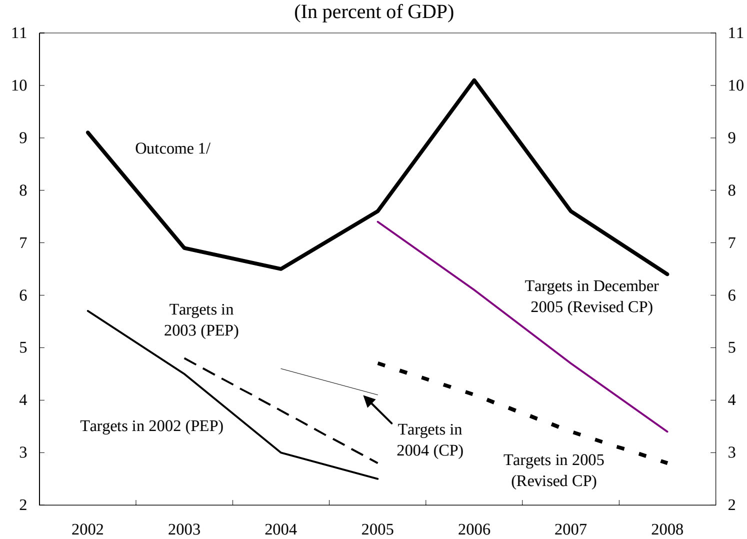
Reform Options	Staff's Proposal
Expenditure reforms	**8.9**
Government employment and wages, and public administration	
(employment cuts, wage freeze and abolition of unusual benefits)	1.5
Health care	0.9
(mainly introduction of co-payments and pharmaceuticals reform)	
Education (notably to obtain economies of scale)	1.0
Government subsidies (housing, transport, energy)	1.5
Pensions (including revisions to formulas and eligibility)	2.1
Social benefits (reduction and better targeting of benefits)	0.6
Caps on expenditures from carryover funds and open-ended items	1.2
Tax reforms	**4.9**
Delay in pending items of 2005 tax reform	2.8
Tax pensions under personal income tax	0.1
Tax interest income and capital gains	0.1
Increase in VAT rate from 15 to 20 percent	0.5
Elimination of exemptions	0.8
Strengthening of real estate tax	0.5
Total	**13.8**

Sources: Staff estimates.

18. **Because the fiscal consolidation needs are so large, staff also argued for broadening the revenue base.** Staff supported some measures under consideration, including taxing pension benefits under the personal income tax, unifying the VAT rate, and taxing all income from fixed-income securities. The authorities' intention of postponing even the desirable elements of the 2005 tax reform is a regrettable necessity. Staff recommended broadening the tax base by eliminating tax exemptions, introducing a more far-reaching real estate tax, and strengthening tax administration. The authorities noted that eliminating exemptions was politically difficult.

19. **Fiscal slippages would continue, staff cautioned, if even well-founded consolidation measures were not accompanied by tighter budgetary controls**. Persistent deficit overshooting has become characteristic of Hungarian public finances, with the projected 2006 excess a new high (Text Figure 16). The restoration of fiscal credibility is, therefore, an important priority. The authorities noted that they did not favor a budgetary council but could contemplate broadening the mandate of the State Audit Office. Staff supported an independent body in either form. Such a body would assess the budget's time consistency and risks, with the requirement of a response to that assessment before parliamentary approval of the budget. At the same time, a medium-term budget framework, with multiyear expenditure ceilings, would provide the benchmarks for guiding policy. The authorities aim to implement new rules for budgeting open-ended expenditures, holding line ministries responsible for meeting targets. This is a welcome development, but ambitious and long-lasting solutions are needed. The practice of allowing budgetary spending without appropriations and parliamentary approval should be discontinued. Quasi-fiscal activities associated with public enterprises and PPPs should be accounted for when setting fiscal deficit targets for the general government. To aid monitoring and ensure timely responses to slippages, quarterly reviews on an ESA'95 basis should be undertaken. The authorities were receptive to staff's proposals, but concrete plans have yet to be formulated.

Text Figure 16. Hungary: Fiscal Deficit Performance and Targets, 2002-08
(In percent of GDP)



Sources: IMF staff estimates; and Hungarian authorities.

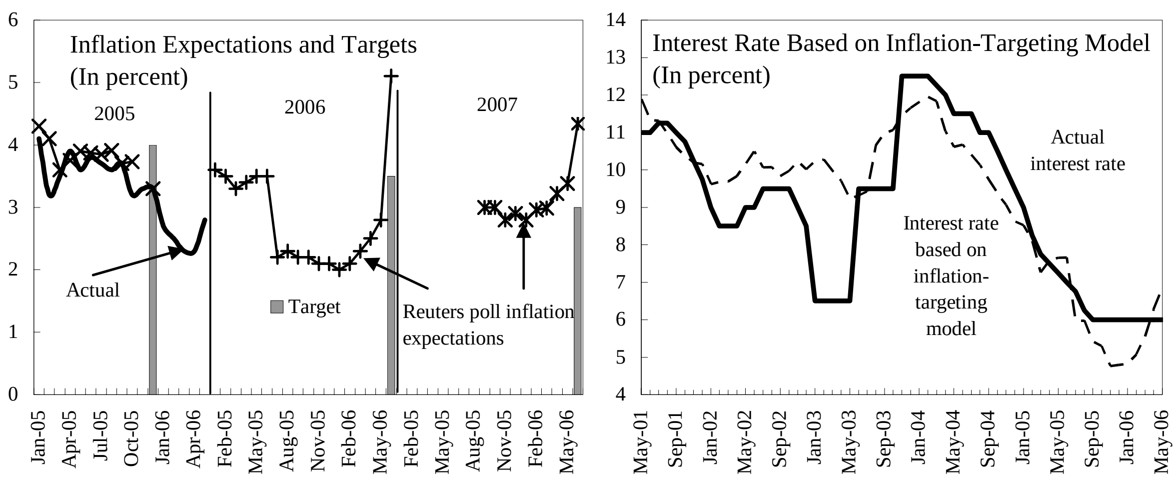
1/ IMF staff projection for 2006-08.
Notes: PEP: Preaccession Economic Program. CP: Convergence Program.

C. Monetary Policy

20. **Staff commended the authorities for strengthening the credibility of inflation targeting.** Through sharp policy rate increases in the midst of currency weakness in 2003, the authorities conveyed support for an exchange rate target. Since then, they have demonstrated greater consistency in targeting an inflation rate, via policy actions and communications. Staff agreed that the commitment to inflation targeting, alongside better anchoring of inflationary expectations, has helped price stability. The commitment was noteworthy in the response to the weakening of the forint in March. That weakening was appropriately evaluated in the context of subdued overall inflationary pressures, and the policy interest rate was held steady despite anticipation by markets that the MNB would prop up the exchange rate. Moreover, the rationale behind the decision was transparently communicated.

21. **With inflation risks on the upside, the authorities indicated that a tightening cycle may be called for.** With the projected reduction of subsidies and tax increases, inflation will exceed the MNB's 3 percent target in 2007 and possibly also in 2008. By itself, this projection does not call for a policy response since, as the authorities noted, the tax changes will likely have one-off effects on inflation. Staff estimates that, absent the recent fiscal measures, inflation would stay within the target band. The authorities, however, agreed that inflationary expectations had recently turned up after a substantial decline (Text Figure 17). They therefore concluded that a tightening cycle in small step increases of the policy rate may be required, especially if second-round effects become evident from the tax and energy price increases and a further depreciation of the forint. The 25-basis-point increase in the policy rate on June 19 was appropriate in this context.

Text Figure 17. Hungary: Monetary Policy, 2001-06

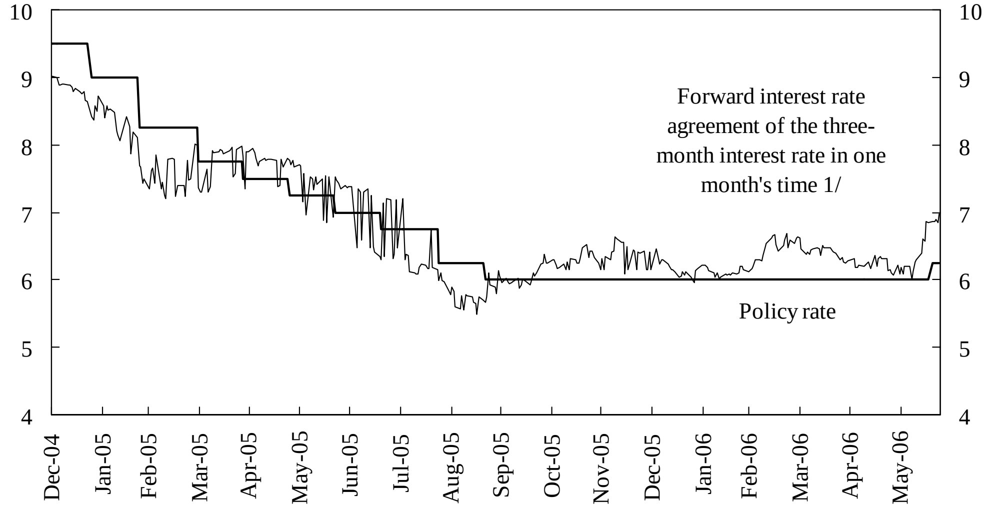


Sources: Reuters; Bloomberg; Magyar National Bank; Hungarian Central Statistical Office; and staff calculations.

22. **The authorities agreed that, in the current uncertain environment, consistency in communication is required to keep inflation expectations anchored.** In particular, a continued steady depreciation or a sharp depreciation beyond the central parity of Ft 282.36 per euro would require clarity on the implications for inflation and monetary tightening (Text Figure 18).[10] A sizable and unexpected interest rate hike to defend the exchange rate, as in 2003, could prove ineffective if rising debt-servicing costs further undermine confidence and add to the policy uncertainty, hurting private investment and the banking sector.

[10] The exchange rate pass-through has declined to about 20 percent over a 24-month span.

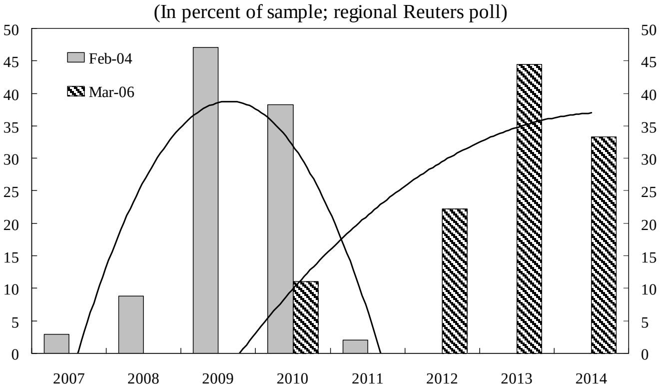
Text Figure 18. Hungary: Policy Rate and Forward Rate Agreement, 2004-06
(In percent)



Source: Bloomberg.
1/ A forward rate agreement (FRA) is an over-the-counter contract that determines the interest rate and period of time on an obligation beginning at some future start date. FRAs are used as a leading indicator of future monetary policy decisions.

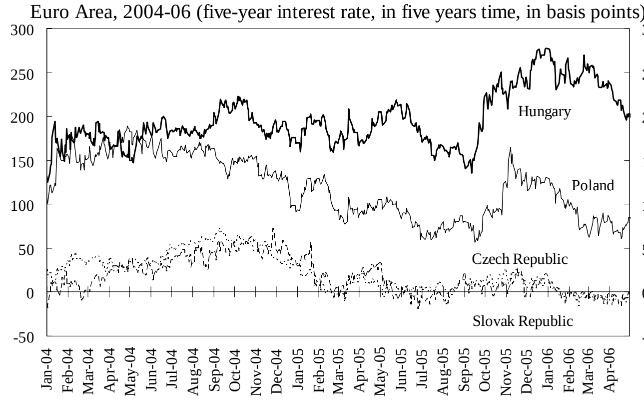
23. **The authorities again rejected calls to shift to a floating exchange rate regime.** Because the band is wide, the authorities argued, it does not currently constrain the pursuit of inflation targeting. Staff, however, noted the risk that, if fundamentals weakened further and international market sentiment worsened, the pressure on the exchange rate could be aggravated by the band. Moreover, with euro adoption far away (Text Figures 19 and 20), an ERM II-like framework will not become pertinent for some years, and greater exchange rate variability will help reduce incentives to borrow in foreign currency. The authorities maintained that any change in regime could result in unpredictable and destabilizing market reactions, as occurred when the central parity was changed in June 2003.

Text Figure 19. Hungary: Distribution of Expected Euro Adoption Date
(In percent of sample; regional Reuters poll)



Source: Reuters.

Text Figure 20. CE-4: Spreads of Long-Term Forward Swap Rate Versus the Euro Area, 2004-06 (five-year interest rate, in five years time, in basis points)



Source: JP Morgan.

D. Financial Sector Stability

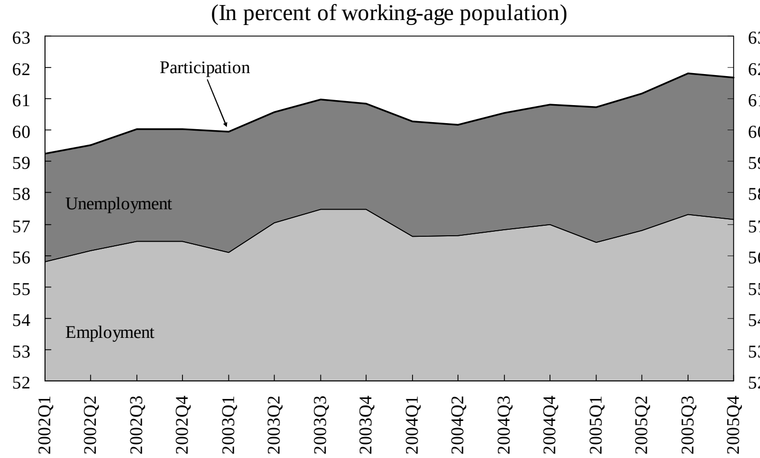
24. **It was agreed that several developments bear close watching.** First, foreign currency lending can be expected to continue its rise. From 53 percent of outstanding loans, foreign currency lending, on current trends, could increase by about 5 percentage points a year. Second, the Senior Loan Officer Survey identifies more aggressive bank lending activities and practices (often through nonbank financial affiliates), which have raised credit risks (though the authorities emphasized this development was also consistent with financial deepening). Finally, the financial fragility of SMEs appears to have increased, as interpreted from the increase in the share of loans on the "watch list" of banks. For the banking sector, the ratio of nonperforming to outstanding loans has remained relatively steady, at about 2½ percent, but with riskier lending and SME fragility, more nonperforming loans may be in the pipeline.

25. **The authorities assess the banking sector as able to withstand substantial shocks, but staff recommended more sophisticated supervisory and precautionary regulatory measures.** The main risk that banks face is that of increased default in the event of a sharp currency depreciation. The authorities reported that, due to short credit histories, the credit risks are difficult to assess. While they are concerned that an exchange rate correction and other macro demand shocks may hurt the repayment capacity of some SMEs and households, they remain confident, and staff agrees, that the risk of a systemic banking crisis is low, with borrowers and banks possessing sufficient buffers. The authorities noted their stepped-up efforts to increase awareness of risks associated with foreign currency lending but also conceded that these efforts had had limited effects. Staff suggested more proactive supervision. More intensive on-site supervision of risk-management practices is needed to ensure that the banks factor in the possibility of a decline in collateral values coincident with heightened credit risk. Staff expressed concern that no stress tests of individual banks had been undertaken since the 2005 FSAP update and, while recognizing the data limitations, emphasized that such tests should become an integral part of the supervision effort. The authorities reported that they were developing a new methodology for stress testing, to be implemented early next year. Staff further proposed consideration of increased risk weights or additional provisioning requirements for foreign currency lending. While the authorities were receptive to stepped-up supervision, they did not view further regulatory measures favorably, since these could be circumvented in open capital markets. Staff noted that such measures were in place in other countries and would signal the authorities' strong concern regarding these trends.

E. Labor Markets and Competitiveness

26. **Raising employment rates remains a priority for the authorities.** Staff analysis in an accompanying selected issues chapter shows the sharp decrease in employee compensation after 1995 stimulated employment generation, thereby increasing the employment-working age population ratio over the past decade (Figure 6). The small share of the slowly growing agricultural sector and generally flexible labor markets also helped. However, at about 57 percent, the employment ratio remains relatively low (Text Figure 21).

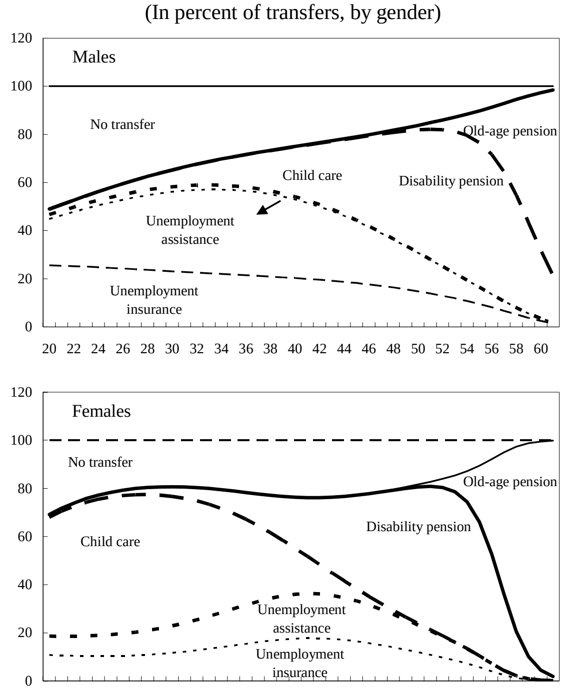
Text Figure 21. Hungary: Labor Force Participation Rate, 2002-05
(In percent of working-age population)



Source: Eurostat.

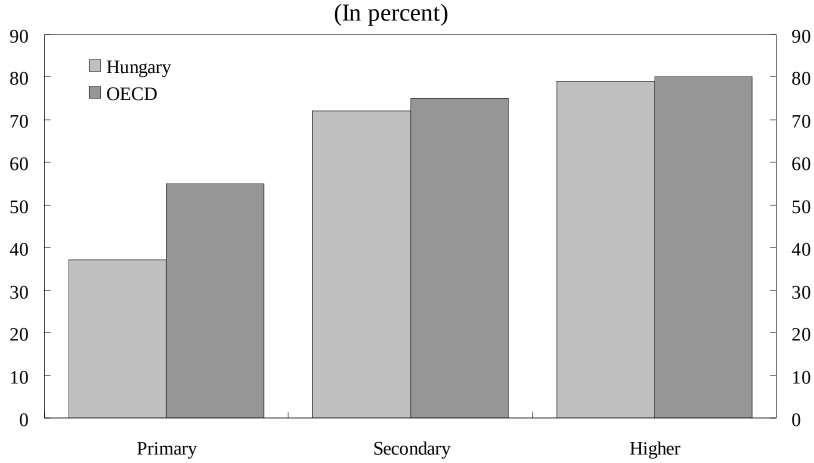
27. **The discussions identified three relevant policy areas.** First, the tax wedge is wide; in the currently weak labor market situation, lowering the tax wedge should reduce employee costs and help generate employment. Second, the welfare system can be rationalized. Both men and women drop out of the labor force to take advantage of the generous disability benefits (Text Figure 22). Child care benefits can also be rationalized to allow for greater scope for temporary and part-time work. Finally, the employment ratio is particularly low among workers with primary education (Text Figure 23). The rapid shift of the Hungarian output structure to relatively skill-intensive activities has implied a low demand for unskilled workers. A greater effort to raise the productivity of unskilled workers and to maintain the economic relevance of higher education must be priorities.

Text Figure 22. Hungary: Distribution of Transfers to Nonemployed Persons, by Age and Transfer Status, 2001
(In percent of transfers, by gender)



Source: Köllő J., 2006, "Skill Endowments in the CEEs–The Legacy of Socialism and Implications for Employment" (unpublished; Budapest: Institute of Economics, Hungarian Academy of Sciences).

Text Figure 23. Hungary: Employment-Population Ratios by Education, 2002
(In percent)



Source: Köllő, J., 2006, "Skill Endowments in the CEEs–The Legacy of Socialism and Implications for Employment," (unpublished; Budapest: Institute of Economics, Hungarian Academy of Sciences).

28. **Staff remains concerned about competitiveness pressures.** The authorities emphasized that, during the period of exchange rate appreciation, export strength was maintained through a counteracting shift from "low-" to "medium-"skilled export products (Figure 7). While recognizing the technological shift and the associated gains in market shares by Hungarian exporters, staff emphasized (as documented in the multi-country selected issues chapter) that competitive pressures are rising and that technological upgrading had become a necessary but not sufficient condition for further penetration into world markets. As noted above, market shares have flattened (see Text Figure 9). Continued emphasis on raising productivity growth and the savings rate remains crucial for long-term external sustainability.

29. **The authorities view the expected step-up in the use of EU funds as an opportunity to raise productivity and improve infrastructure.** The absorption of EU funds has been growing and is likely to increase further, from about 2 percent of GDP in 2006 to 2.7 percent of GDP in 2008 (net inflows will be about 1 percentage point less, reflecting Hungary's payments to the EU) (Text Table 6). Projects related to small and medium-sized enterprises' technology upgrading, the road network, and education and training are moving ahead steadily. These are encouragingly linked to much-needed productivity growth. However, measures to improve employment adaptability and increase access to the global information network are lagging. Staff emphasized, and the authorities agreed, that continued efforts based on cost-benefit analysis are needed to utilize the remaining structural funds by end-2008 and administer a threefold increase in new commitments for 2007-13. Absent fiscal structural reforms, the effectiveness of these resources will likely be diminished.

Text Table 6. Hungary: Spending of EU Funds, 2004-08

	2004	2005	2006	2007	2008
			Projections		
			(In billions of forint)		
EU funds	114.0	402.0	486.0	539.0	709.0
Agriculture 1/	13.0	222.0	194.0	185.0	223.0
Structural funds 2/	4.0	86.0	169.0	176.0	243.0
Cohesion funds 3/	10.0	23.0	51.0	100.0	189.0
Other	9.0	23.0	46.0	71.0	52.0
Budget compensation	43.0	8.0	8.0	0.0	0.0
Pre-accession aid	35.0	40.0	18.0	7.0	3.0
			(In percent of GDP)		
EU funds	0.6	1.8	2.1	2.2	2.7
Agriculture 1/	0.1	1.0	0.8	0.7	0.8
Structural funds 2/	0.02	0.4	0.7	0.7	0.9
Cohesion funds 3/	0.05	0.1	0.2	0.4	0.7
Other	0.04	0.1	0.2	0.3	0.2
Budget compensation	0.2	0.0	0.0	0.0	0.0
Pre-accession aid	0.2	0.2	0.1	0.0	0.0

Sources: Data provided by the authorities; and staff estimates.
1/ Excluding Special Accession Programme for Agriculture and Rural Development (SAPARD), which is included in preaccession aid.
2/ Including 25 percent advance paid in 2005.
3/ Instrument for Structural Policies for Pre-Accession (ISPA) included in Cohesion Funds 2004.

III. Staff Appraisal

30. **Despite the economy's many strengths, its growth is at risk, and a loss of market confidence and a sharp contraction in output cannot be ruled out.** Extensive engagement in European production networks, the continuing technological and quality upgrading of the production structure, and buoyancy in export growth indicate the resilience of the private sector despite macroeconomic uncertainties. Economic growth in recent years, however, owes much to a strong fiscal stimulus. With a needed fiscal contraction now planned for 2007, growth can be expected to slow. Indeed, a largely tax-based consolidation risks reducing competitiveness and increasing policy uncertainty, since some of the new taxes will eventually need to be reversed. The greater short-term risk arises from the inability to implement a significant consolidation, which could further undermine investor confidence and, interacting with the financial market volatility, force an involuntary contraction in the current account and, hence, in output.

31. **The principal policy task is to place public finances on a sound footing.** A fiscal consolidation, sustained over a longer period than currently envisaged by the authorities and, hence, somewhat more sizable, would reduce vulnerabilities and lower the debt ratio to below the Maastricht limit, allowing euro entry from a position of strength. Furthermore, a focus on expenditure reforms, including improved expenditure targeting and efficiency, will contribute to lasting consolidation. Revenue enhancement is also required and should be achieved through a broadening of the tax base, including instituting a more far-reaching

property tax, rather than through surcharges on already high taxes on capital and labor. Of paramount importance, the endemic overruns in the budget deficit must be stemmed, through stronger controls, and greater transparency and accountability.

32. **For monetary policy, the challenge is to identify one-off inflationary influences, communicate these to the public and financial markets, and deal with second-round effects.** Much progress has been achieved in establishing the credibility of the inflation-targeting framework. These gains will be consolidated by continued consistent actions and communications. Currently, the risks to inflation are mainly on the upside, but contributory factors may have primarily one-off effects. The concern is that, despite better anchoring than in the past, short-term inflation spikes may raise inflationary expectations. Communicating the nature and extent of the one-off effects, therefore, is important for containing the expectation of a medium-term rise in inflation. If the likelihood of second-round effects increases, anticipatory policy tightening will be required. However, in this uncertain environment, a measured course of tightening, rather than sharp changes in policy rates, will likely better serve the goal of maintaining stable expectations. Hence, the June policy rate increase and the prospect of a tightening cycle represent the right stance.

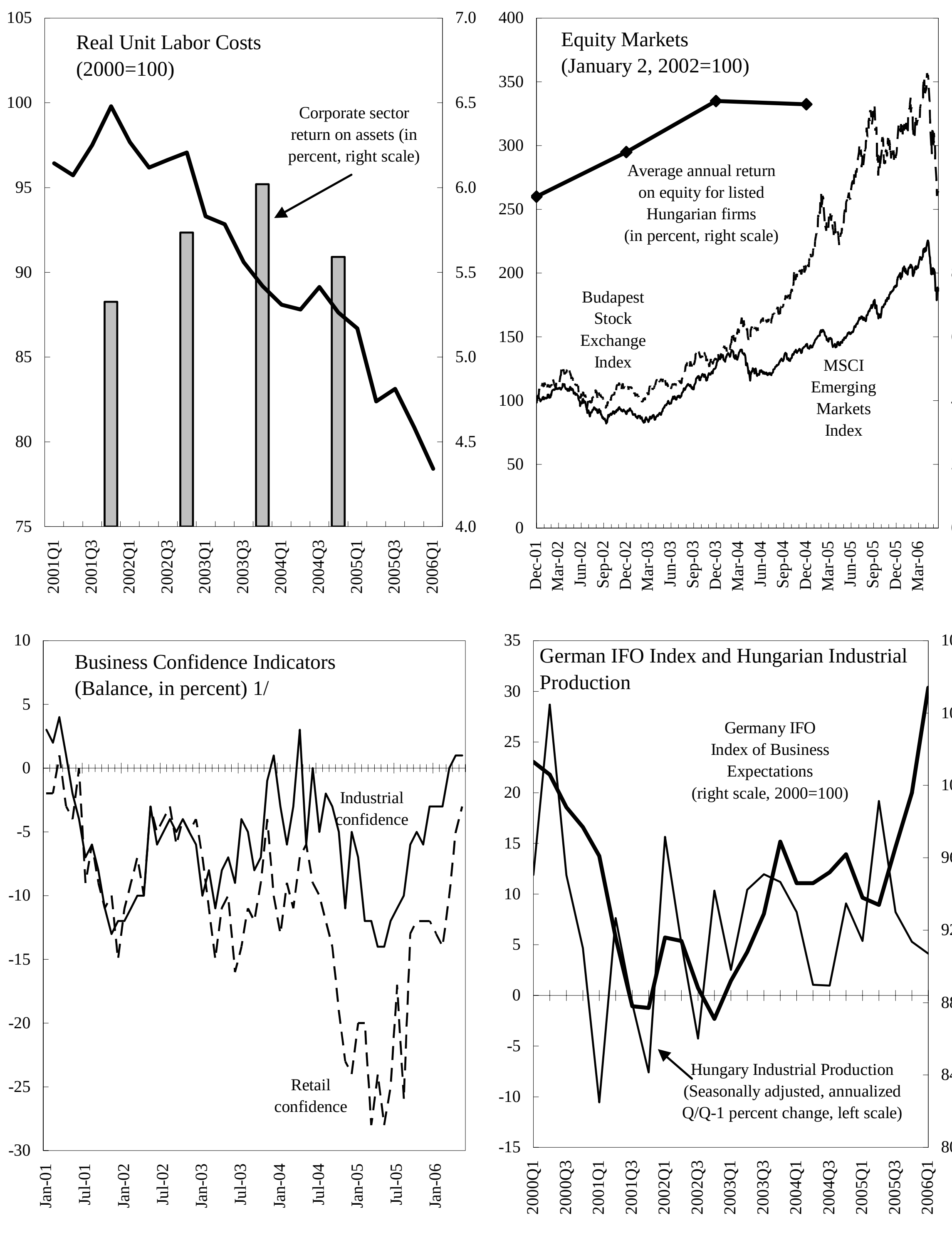
33. **From a risk-management perspective, a floating exchange rate regime is best suited to Hungary's present needs.** With euro adoption some distance away, an ERM II-like exchange rate band is not currently relevant. If anything, its presence interferes with the operation of the inflation-targeting anchor. If global imbalances unwind, they may interact with domestic vulnerabilities in unpredictable ways, creating additional policy challenges. Moreover, the perception of greater exchange rate variability will help reduce incentives to borrow in foreign currency.

34. **Although the banking sector has valuable safeguards, recent trends call for more proactive supervision and regulation.** The profitability and capitalization of the banking system remain robust. However, the steady increase in foreign currency lending and signs of worsening credit quality are causes for concern. The authorities should institute regular stress tests of individual banks. More intensive on-site supervision of banks' risk-management practices, especially with respect to their foreign currency lending, is needed. Consideration should also be given to requiring higher provisioning against foreign currency loans.

35. **Improving labor market performance and enhancing competitiveness are tied in important ways to fiscal reforms.** A reduction in the overall cost of labor is important for increasing employment. In turn, this requires reducing the tax wedge, a goal rendered difficult by the current fiscal position. Raising the employment rate will require targeting social welfare programs more effectively, especially the disability pension and early retirement programs. While the trade-weighted exchange rate is not obviously overvalued, a broader perspective highlights that productivity enhancement will be crucial for maintaining competitiveness. The improved pace of EU funds' absorption in productivity-enhancing activities is encouraging. Ensuring that the funds are effectively used will require linking their deployment to fiscal structural reforms.

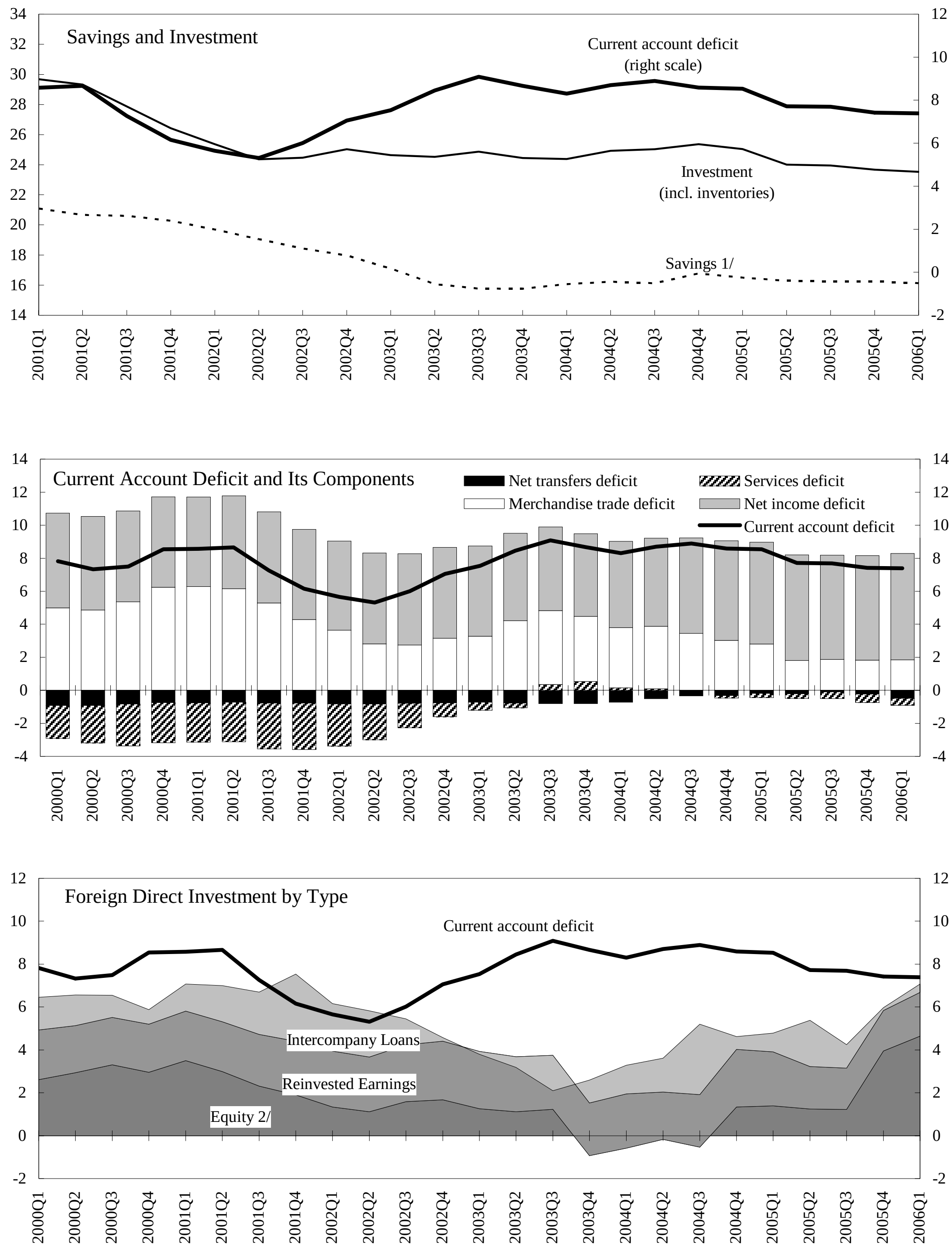
36. The next Article IV consultation with Hungary is expected to be conducted under the standard 12-month cycle.

Figure 1. Hungary. Selected Indicators of Business Profitability and Sentiment, 2001-06



Sources: Magyar National Bank; Hungary Statistical Office; European Commission; Bloomberg; and IFO.
1/ Percent share of positive responses less percent share of negative responses.

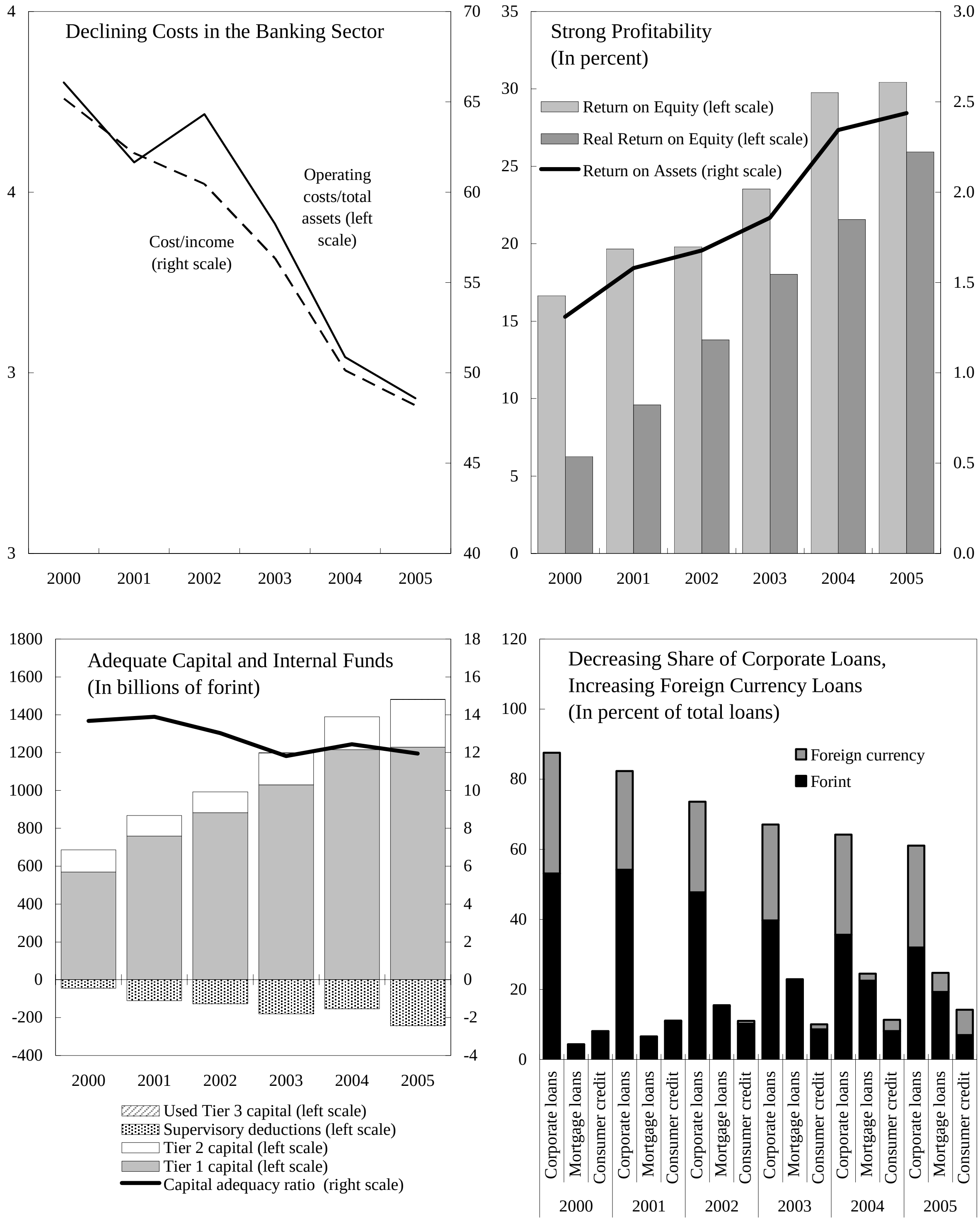
Figure 2. Hungary: External Sector Indicators, 2000-06
(In percent of GDP, four-quarter rolling basis)



Sources: Magyar National Bank; Hungary Statistical Office; and staff estimates.

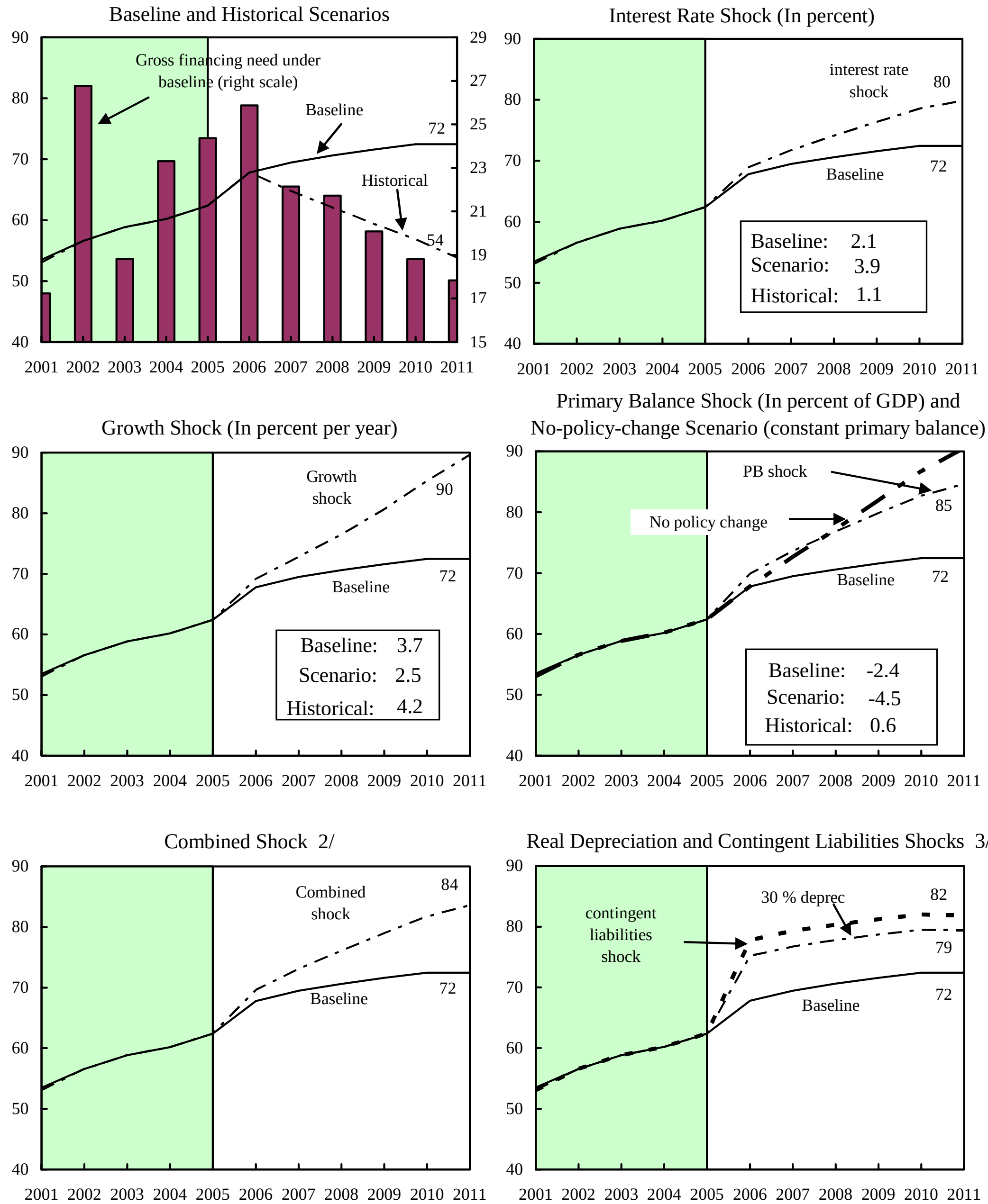
1/ Derived from balance of payments statistics as investment plus the current account deficit.
2/ 2005 FDI includes privatization receipts from the sale of Budapest Airport (about 2 percentage points of GDP).

Figure 3. Hungary: Indicators of Banking Sector Soundness, 2000-05



Source: Magyar National Bank.

Figure 4. Hungary: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



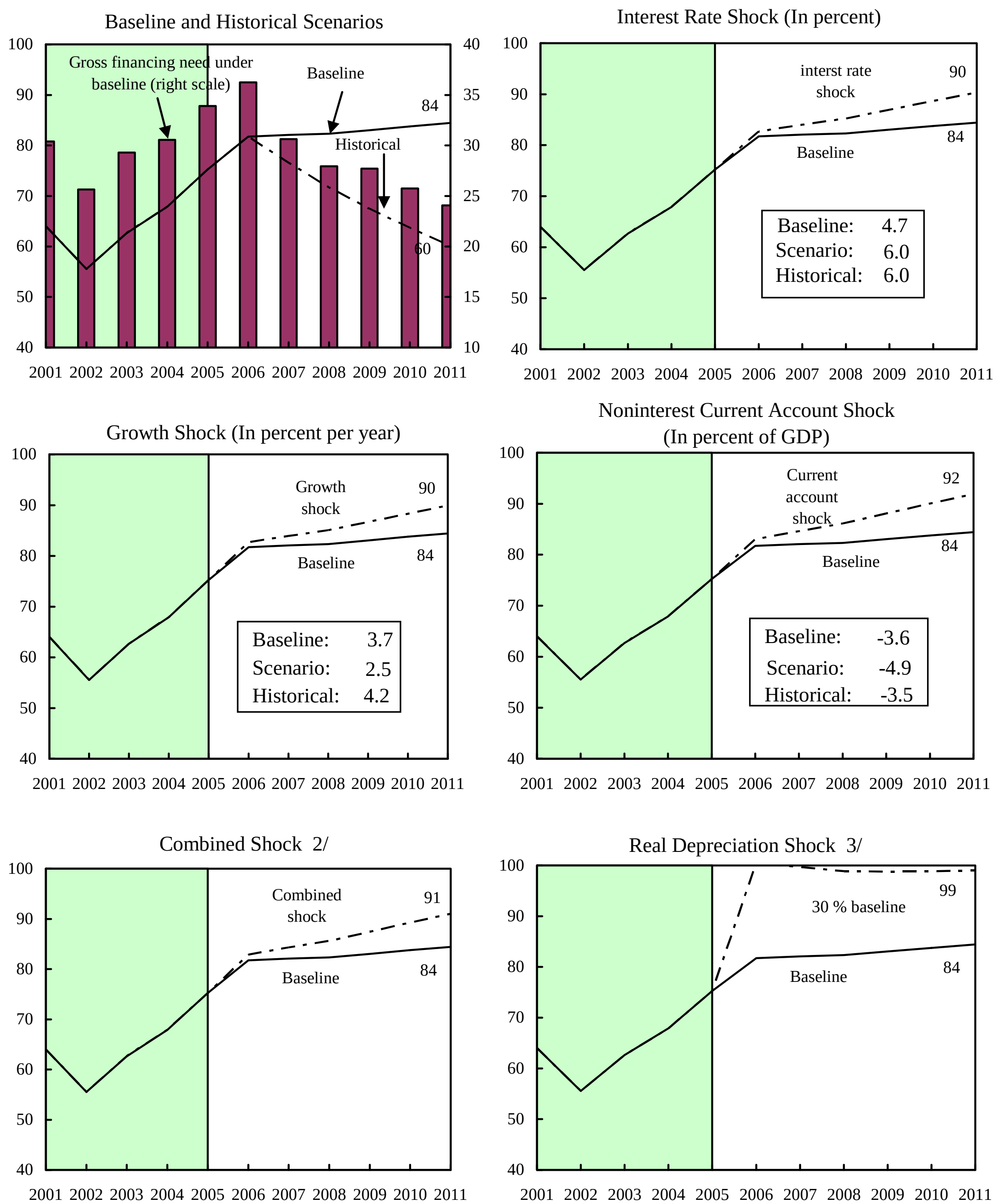
Sources: International Monetary Fund; Hungary desk data; and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half-standard-deviation shocks (one-standard-deviation shock for growth). Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent one-fourth-standard-deviation shocks applied to real interest rate, growth rate, and primary balance.

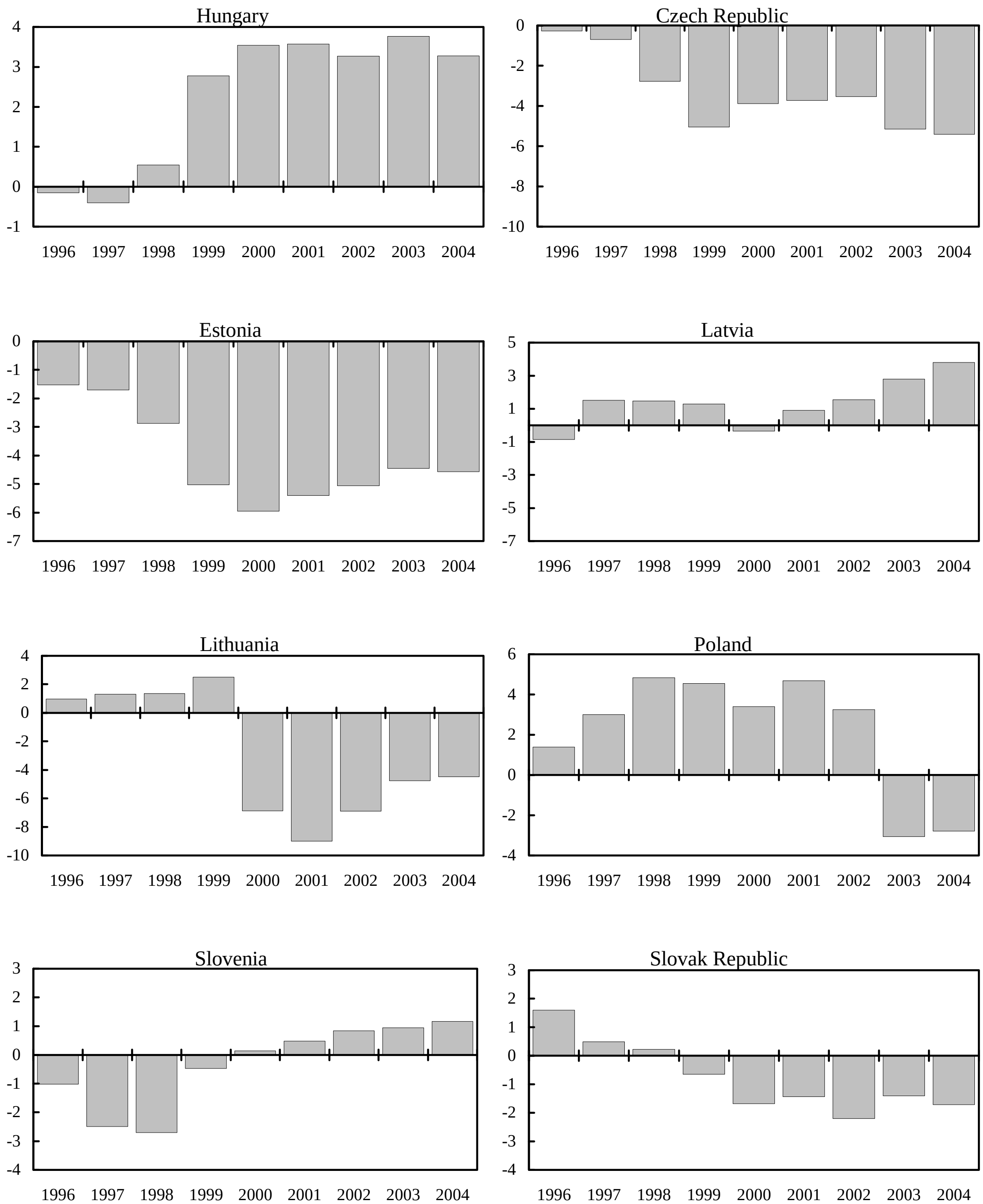
3/ Onetime real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities in 2006, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Figure 5. Hungary: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



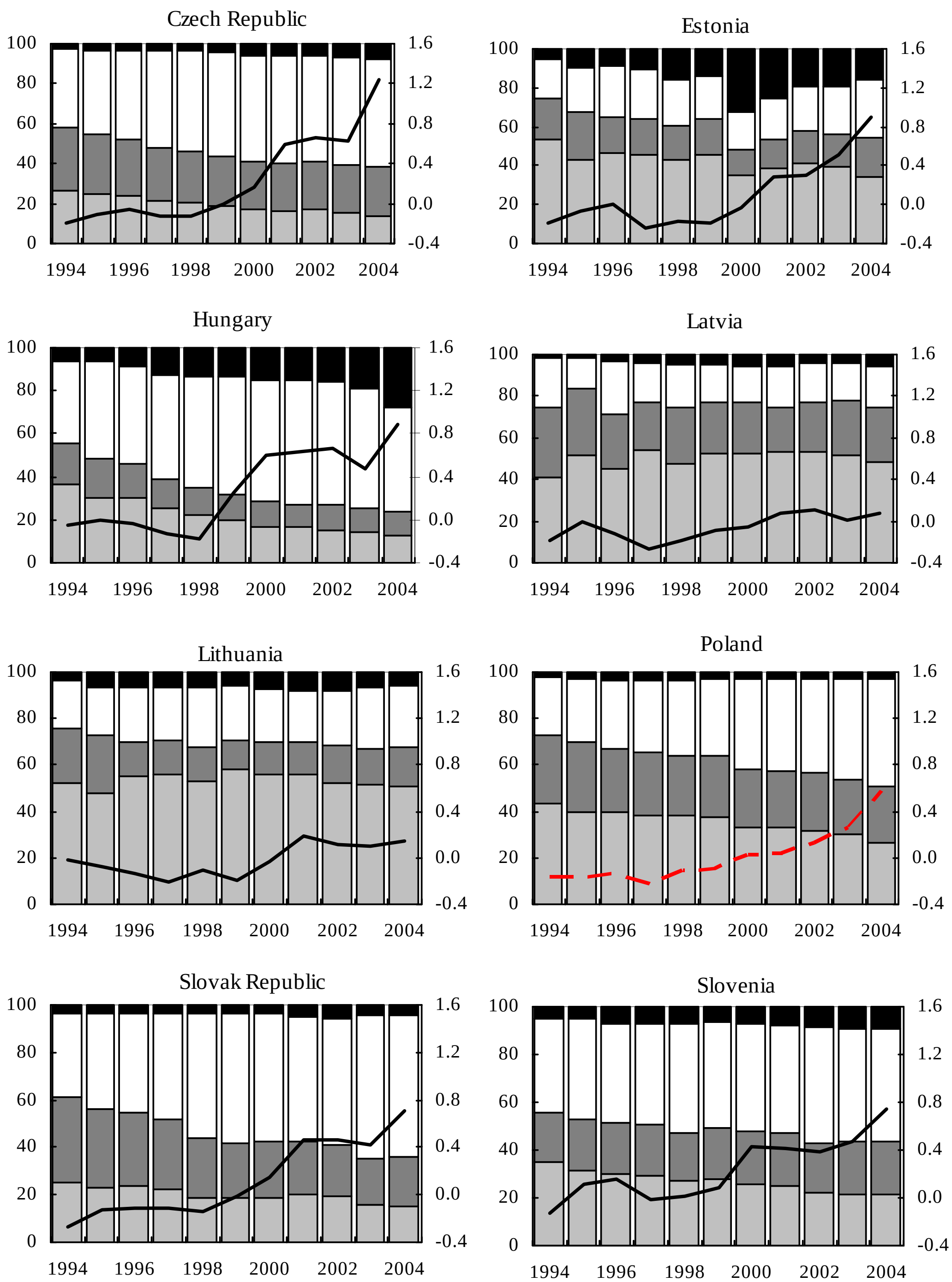
Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-standard-deviation shocks (one-half-standard-deviation shock for the current account). Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent one-fourth-standard-deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ Onetime real depreciation of 30 percent occurs in 2006.

Figure 6. CEECs: Employment Growth Relative to Benchmark Developments, 1996-2004 1/
(In percent)



Source: IMF staff calculations.
1/ The benchmark is based on average employment growth in 14 sectors.

Figure 7. CEECs: Structure of Exports, 1994-2004
(In percent of total exports)



Sources: UN Comtrade; and staff calculations.

1/ UVR is the unit value of a country's exports divided by the unit value of world exports.

Table 1. Hungary: Main Economic Indicators, 2002–07

	2002	2003	2004	2005	2006	2007
					Proj.	Proj.
Real economy (change in percent)						
Real GDP	3.8	3.4	5.2	4.1	4.5	3.5
Private consumption	9.8	7.7	3.6	1.4	3.3	2.3
Gross fixed investment	10.2	2.9	8.0	6.6	7.3	6.2
Exports	3.9	6.1	15.8	10.8	12.2	7.7
Imports 1/	6.6	9.3	13.5	6.5	11.9	7.5
CPI (end year)	4.8	5.7	5.5	3.3	5.4	5.5
CPI (average)	5.3	4.7	6.8	3.6	3.5	5.8
Unemployment rate (in percent)	5.8	5.9	6.1	7.2	7.4	8.1
Gross domestic investment (percent of GDP) 2/	25.0	24.4	25.4	23.7	25.5	26.4
Gross national saving (percent of GDP, from BOP)	18.0	15.8	16.8	16.3	16.3	18.4
General government (percent of GDP), ESA-95 basis 3/						
Overall balance	-9.1	-7.3	-6.5	-7.6	-10.1	-7.6
Primary balance	-5.5	-3.5	-2.5	-3.7	-6.2	-3.7
Debt	56.6	58.9	60.2	62.4	67.8	69.5
Money and credit (end-of-period, percent change)						
M3	9.3	12.0	11.6	14.6	...	...
Credit to nongovernment	21.9	34.4	19.2	18.8	...	...
Interest rates (percent)						
T-bill (90-day, average)	8.9	8.2	11.1	6.8	...	...
Government bond yield (5-year, average)	7.8	7.3	9.2	6.8	...	...
Balance of payments						
Trade balance (percent of GDP) 1/	-3.2	-3.9	-3.0	-1.8	-3.3	-2.7
Current account (percent of GDP) 1/	-7.1	-8.7	-8.6	-7.4	-9.1	-8.0
Reserves (in billions of US dollars)	10.4	12.8	16.0	18.6	18.9	19.5
Gross external debt (percent of GDP) 4/	55.5	62.7	67.9	75.2	81.8	82.2
Net external debt (percent of GDP) 4/	23.3	29.1	32.7	34.6	40.6	41.6
Exchange rate						
Exchange regime	Peg against euro, with band +/-15 percent					
Present rate (June 23, 2006)	Ft 222.72 = US$1					
Nominal effective rate (1990=100)	38.9	38.8	39.6	39.2	...	...
Real effective rate, CPI basis (1990=100)	166.2	170.1	181.3	182.8	...	...

Sources: Hungarian authorities; IMF, *International Financial Statistics*; Bloomberg; and staff estimates.

1/ The central bank believes that due to methodological changes, 2005 imports may be understated by up to 2 percentage points of GDP.
2/ Includes change in inventories.
3/ Consists of the central budget, social security funds, extrabudgetary funds, and local governments. Includes the costs of pension reform.
4/ Including intercompany loans, and nonresident holdings of forint-denominated assets.

Table 2. Hungary: Consolidated General Government, 2002-06 1/
(In percent of GDP, unless otherwise indicated)

	2002	2003	2004	2005	2006		
				Est.	Budget	Proj. Staff	Proj. Auth.
Total revenues	43.0	42.5	43.1	43.2	42.2	43.2	43.7
Current revenues and current grants	42.5	42.1	42.6	42.4	40.9	41.8	42.3
Tax revenues total	38.4	38.2	38.0	37.7	36.2	36.7	37.2
Taxes on income	10.0	9.3	8.8	8.8	8.9	9.0	9.1
Personal income tax	7.6	7.1	6.7	6.7	6.8	6.8	6.8
Corporate income tax	2.3	2.2	2.2	2.1	2.1	2.1	2.1
Other income tax	0.0	0.0	0.0	0.0	0.0	0.1	0.2
Social security contributions	13.1	12.7	12.5	12.8	12.6	12.5	12.7
Taxes on production and imports	15.1	15.8	16.2	15.6	14.3	14.8	14.9
of which : VAT	7.9	8.3	8.9	8.4	7.6	7.9	8.0
Property taxes	0.3	0.3	0.4	0.4	0.3	0.3	0.4
Other taxes	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Current non tax revenues total	3.9	3.7	4.2	3.9	3.1	3.2	3.2
Of which : interest	0.4	0.3	0.3	0.2	0.2	0.2	0.2
Current grants	0.2	0.2	0.3	0.8	1.6	1.9	1.9
Capital revenues and capital grants	0.5	0.4	0.5	0.8	1.3	1.4	1.4
Total expenditures	52.1	49.8	49.5	50.7	48.6	53.3	53.2
Current expenditures and current transfers	43.0	44.3	44.7	45.5	42.1	45.5	45.2
Goods and services	19.0	20.0	19.3	18.8	16.9	17.7	17.6
Of which : wages and salaries 2/	12.4	13.3	12.8	12.6	11.6	11.6	11.6
Transfers	20.0	20.2	21.0	22.6	21.7	23.8	23.6
Of which : to households	16.2	16.8	17.1	18.0	16.2	17.8	17.6
Interest payments	4.1	4.1	4.4	4.1	3.5	4.1	4.1
Capital expenditures and capital transfers	9.1	5.5	4.8	5.2	5.9	7.7	7.8
Capital expenditures 3/	4.9	3.3	3.3	3.3	3.1	4.2	4.2
Capital transfers	4.2	2.3	1.6	1.8	2.8	3.6	3.6
Other net expenditure	0.0	0.0	0.0	0.0	0.6	0.1	0.2
General government balance	-9.1	-7.3	-6.5	-7.6	-6.4	-10.1	-9.5
Net interest	-3.7	-3.8	-4.0	-3.9	-3.3	-3.9	-3.9
Primary balance	-5.5	-3.5	-2.5	-3.7	-3.1	-6.2	-5.6
General government balance (excluding the costs of pension reform)	-8.4	-6.4	-5.4	-6.2	-5.0	-8.7	-8.0
Memorandum items:							
GDP, in current prices (forint billions)	16,915	18,651	20,429	21,802	23,270	23,590	23,140
Gross debt (including the costs of pension reform)	56.6	58.9	60.2	62.4	63.2	67.8	...
Gross debt (excluding the costs of pension reform)	55.0	56.7	57.1	58.4	58.5	63.2	...

Sources: Hungarian authorities; and staff estimates.

1/ Data are classified following the ESA'95 methodology.
2/ Including social security contributions.
3/ Including the cost of aircraft lease in 2006 of 0.3 percent of GDP.

Table 3. Hungary: Balance of Payments, 2002-08
(In billions of U.S. dollars, unless otherwise indicated)

	2002	2003	2004	2005	2006	2007	2008
					Projection		
Current account balance	-4.6	-7.2	-8.7	-8.1	-9.5	-8.7	-8.8
In percent of GDP	*-7.1*	*-8.7*	*-8.6*	*-7.4*	*-9.1*	*-8.0*	*-7.6*
Merchandise trade balance	-2.1	-3.3	-3.0	-2.0	-3.4	-2.9	-3.2
In percent of GDP	*-3.2*	*-3.9*	*-3.0*	*-1.8*	*-3.3*	*-2.7*	*-2.7*
Exports goods	34.7	43.3	56.0	61.9	71.3	77.3	82.5
Percentage change in volume	6.0	9.0	18.7	10.5	12.9	7.8	6.6
Imports goods 1/	36.7	46.6	59.0	63.9	74.7	80.2	85.6
Percentage change in volume	5.1	9.9	15.6	5.2	13.5	6.7	6.7
Services balance	0.6	-0.5	0.2	0.6	0.0	0.2	0.2
Of which: net travel	1.6	1.5	1.2	1.3	1.4	1.4	1.4
Net income	-3.6	-4.2	-6.1	-6.9	-7.2	-7.2	-7.7
In percent of GDP	*-5.5*	*-5.0*	*-6.0*	*-6.3*	*-6.9*	*-6.6*	*-6.6*
Net transfers	0.5	0.7	0.3	0.2	1.1	1.2	1.9
In percent of GDP	*0.8*	*0.8*	*0.3*	*0.2*	*1.0*	*1.1*	*1.6*
Capital account, net	0.2	0.0	0.3	0.9	1.0	1.6	1.7
Financial account, net	2.5	7.6	12.0	14.6	8.8	7.7	7.0
Net direct investment	2.7	0.5	3.6	5.2	2.3	2.7	2.5
Net portfolio investments	1.9	3.3	7.3	4.3	3.6	3.0	2.6
Net other investments	-2.1	3.8	1.2	5.1	2.9	2.0	1.9
Errors and omissions	0.1	0.2	-1.7	-2.5	0.0	0.0	0.0
Overall balance	-2.0	0.4	3.6	7.4	0.3	0.6	-0.1
Net reserves (change)	2.0	-0.4	-3.6	-7.4	-0.3	-0.6	0.1
Memorandum items (end of period):							
Gross reserves	10.4	12.8	16.0	18.6	18.9	19.5	19.4
In months of goods and services imports	*2.9*	*2.8*	*2.8*	*2.9*	*2.6*	*2.5*	*2.3*
Gross foreign debt, in percent of GDP 2/	*55.5*	*62.7*	*67.9*	*75.2*	*81.8*	*82.2*	*82.5*
Net foreign debt, in percent of GDP 3/	*23.3*	*29.1*	*32.7*	*34.6*	*40.6*	*41.6*	*43.1*

Sources: Hungary National Bank; and staff estimates.
1/ The central bank believes that due to methodological changes, 2005 imports may be understated by up to 2 percentage points of GDP.
2/ Including intercompany loans.
3/ Foreign liabilities net of foreign assets, excluding equity but including intercompany loans.

Table 4. Selected Vulnerability Indicators, 2000-05
(In percent of GDP, unless otherwise indicated)

	2000	2001	2002	2003	2004	2005
Current account balance						
Hungary	-8.5	-6.1	-7.1	-8.7	-8.6	-7.4
Argentina	-3.2	-1.4	9.0	6.2	1.4	1.8
Brazil	-4.0	-4.5	-1.6	0.8	2.0	1.8
Latvia	-4.8	-7.6	-6.6	-8.1	-12.9	-12.5
Poland	-6.0	-2.9	-2.6	-1.9	-1.6	-1.6
Slovak Republic	-3.5	-8.4	-8.0	-0.9	-3.0	-7.2
Turkey	-4.9	2.4	-0.8	-3.3	-4.9	-6.3
GIR to short-term debt 1/						
Hungary	118	133	116	106	85	106
Argentina	62	59	45	26	38	70
Brazil	49	52	56	59	84	69
Latvia	---	29	34	27	23	27
Poland	---	133	123	106	106	104
Slovak Republic	102	100	95	132	108	104
Turkey	53	51	51	76	77	63
External debt						
Hungary	64	64	56	63	68	75
Argentina	52	52	132	115	100	74
Brazil	39	41	45	43	38	21
Latvia	61	68	76	82	85	94
Poland	42	39	44	50	48	46
Slovak Republic	53	53	54	56	48	56
Turkey	59	78	71	61	54	50
REER (2000=100)						
Hungary	100	107	119	122	130	133
Argentina	100	104	46	48	46	..
Brazil	100	84	80	77	81	..
Latvia	100	98	96	92	93	..
Poland	100	113	108	96	96	107
Slovak Republic	100	102	105	105	105	119
Turkey	100	79	85	94	97	..
Fiscal balance						
Hungary	-2.8	-4.2	-9.1	-7.3	-6.5	-7.6
Argentina	3.6	-5.9	-1.5	1.3	3.7	2.5
Brazil	-3.6	-3.6	-4.6	-5.2	-2.8	-3.3
Latvia	-3.0	-2.0	-2.4	-1.6	0.2	-1.0
Poland	-3.0	-5.3	-6.3	-5.8	-7.0	-4.8
Slovak Republic	-12.3	-6.0	-5.7	-3.4	-3.6	-3.8
Turkey	-11.2	-20.0	-15.1	-11.1	-7.5	-3.1

Source: PDR Quarterly Assessment of Vulnerabilities in Emerging Countries, March 2006.
1/ GIR are stocks at end of previous year; the denominators are current-year data.

Table 5. Financial Soundness Indicators for the Banking Sector, 2000-05
(End of period; in percent, unless otherwise indicated)

	2000	2001	2002	2003	2004	2005
Capital adequacy						
Regulatory capital to risk-weighted assets	13.7	13.9	13.0	11.8	12.4	10.7
Capital (net worth) to assets	8.3	8.5	8.7	8.3	8.5	8.3
Asset composition and quality						
Annual growth of bank loans	31.6	17.2	23.7	33.2	16.9	19.8
Sectoral distribution of bank loans (in percent of total)						
Corporates	70.5	65.3	53.7	49.5	48.4	45.7
o/w in foreign currency	...	22.3	18.9	20.2	21.6	21.8
Households	10.0	14.1	19.3	24.3	27.0	29.2
o/w in foreign currency	...	0.4	0.8	1.2	3.9	9.5
Other loans	19.4	20.7	27.0	26.2	24.6	25.0
o/w in foreign currency	...	14.3	16.9	18.3	17.4	18.8
Financial institutions	5.1	7.1	9.7	11.6	12.5	12.3
Central government	1.5	1.1	5.0	1.5	1.1	0.6
Nonresidents	7.4	8.8	6.9	6.5	4.5	5.1
Other	5.4	3.7	5.4	6.6	6.5	7.0
Denomination of foreign currency loans to corporates						
EUR	61.9	69.5	77.6	84.8	79.3	74.8
USD	35.6	27.8	19.3	9.8	6.7	5.7
CHF	1.7	2.6	2.8	5.3	13.9	19.3
Other	0.7	0.2	0.3	0.1	0.1	0.2
NPLs to gross loans	3.0	2.7	2.9	2.6	2.7	2.5
Provisions to NPLs	57.0	57.9	50.8	47.3	51.3	54.4
NPLs net of provisions to capital		7.3	10.0	10.7	10.0	8.9
Earnings and profitability						
ROA (after tax)	1.1	1.3	1.4	1.5	2.0	2.0
ROE (after tax)	13.5	15.8	16.2	19.3	25.3	24.6
Net interest income to gross income	68.6	67.9	68.1	65.5	65.9	64.4
Noninterest expenses to gross income	65.2	61.8	60.4	56.4	50.1	48.6
Personnel expenses to noninterest expenses	39.6	41.2	42.9	43.4	45.7	47.2
Trading and fee income to total income	30.0	31.2	30.4	31.4	32.3	33.9
Spread between loan and deposit rates	3.8	4.0	4.0	3.7	3.6	3.7
Liquidity						
Liquid assets to total assets	31.8	29.9	24.3	19.5	21.1	21.0
Liquid assets to short term liabilities	46.5	43.7	36.0	31.4	35.6	35.8
Loans to deposits	74.7	77.0	84.6	99.7	103.7	107.7
Foreign currency liabilities (own capital is excluded) to total liabilities (own capital is excluded)	39.1	36.7	29.4	30.5	30.0	34.5
Sensitivity to market risk						
Net open position in foreign currency to capital	-0.4	6.9	2.1	2.1	6.0	3.5

Source: Magyar National Bank.

Table 6. Hungary: Staff's Illustrative Medium-Term Scenario, 2002-10

	2002	2003	2004	2005	2006	2007	2008	2009	2010
					Staff projections				
	(In percent, unless otherwise indicated)								
Real GDP growth	3.8	3.4	5.2	4.1	4.5	3.5	3.7	3.7	3.8
Nominal GDP, forint billions	16,915	18,651	20,429	21,802	23,590	25,832	27,957	30,006	32,081
Inflation (CPI; end-year basis)	4.8	5.7	5.5	3.3	5.4	5.5	3.5	3.0	3.0
	(Annual percentage change, constant prices)								
Domestic demand	5.9	6.0	4.1	0.8	4.3	3.4	3.8	3.8	4.2
Consumption	9.4	7.7	3.2	1.1	3.5	2.2	2.9	3.0	3.5
Gross fixed capital formation	10.2	2.9	8.0	6.6	7.3	6.2	5.8	5.5	5.8
Exports of GNFS	3.9	6.1	15.8	10.8	12.2	7.7	6.6	6.3	6.6
Imports of GNFS	6.6	9.3	13.5	6.5	11.9	7.5	6.6	6.3	7.0
	(In percent of GDP)								
External current account balance	-7.1	-8.7	-8.6	-7.4	-9.1	-8.0	-7.6	-7.4	-7.1
Gross national saving	18.0	15.8	16.8	16.3	16.3	18.4	19.5	20.2	20.9
Gross national investment 1/	25.0	24.4	25.4	23.7	25.5	26.4	27.0	27.6	28.0
Gross external debt 1/	55.5	62.7	67.9	75.2	81.8	82.2	82.5	83.2	84.0
Private sector savings-investment balance 3/	-5.9	-4.5	-3.6	-0.5	1.0	-0.4	-1.2	-1.6	-1.6
Gross private savings	15.6	14.9	18.1	19.6	22.8	22.2	22.3	22.3	23.4
Gross private investment	21.5	19.4	21.8	20.1	21.8	22.6	23.4	23.9	25.0
General government (ESA-95)									
Revenue, primary	42.6	42.2	42.8	43.0	43.0	44.6	45.0	45.0	45.0
Expenditure, primary	48.1	45.7	45.3	46.7	49.3	48.4	47.5	47.1	47.0
Primary balance	-5.5	-3.5	-2.5	-3.7	-6.2	-3.7	-2.5	-2.1	-1.9
General government balance (including the costs of pension reform)	-9.1	-7.3	-6.5	-7.6	-10.1	-7.6	-6.4	-5.8	-5.5
General government balance (excluding the costs of pension reform) 4/	-8.4	-6.4	-5.4	-6.2	-8.7	...	...	...	...
Net interest	3.7	3.8	4.0	3.9	3.9	3.9	3.9	3.7	3.6
General government debt	56.6	58.9	60.2	62.4	67.8	69.5	70.6	71.6	72.5
General government debt (excluding the costs of pension reform) 4/	55.0	56.7	57.1	58.4	63.2	...	...	...	...
Memorandum items									
Output gap	-0.4	-0.9	-0.3	-0.2	0.2	-0.4	-0.8	-1.2	-1.5
Structural general government balance	-9.0	-7.0	-6.4	-7.5	-10.2	-7.4	-6.2	-5.4	-5.1
Structural primary balance	-5.3	-3.2	-2.4	-3.7	-6.3	-3.5	-2.3	-1.7	-1.5

Sources: Hungarian authorities; and staff estimates.

1/ Includes change in inventories.
2/ Includes intercompany loans.
3/ Consistent with the balance of payments data (not necessarily with the national accounts data).
4/ The exclusion of the costs of the pension reform is as allowed by Eurostat.

Table 7. Hungary: Public Sector Debt Sustainability Framework, 2001-11
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Debt-stabilizing primary balance 1/
1 **Baseline: Public sector debt 2/**	53.5	56.6	58.9	60.2	62.4	**67.8**	**69.5**	**70.6**	**71.6**	**72.5**	**72.5**	**-1.0**
o/w foreign-currency denominated	17.5	14.3	14.3	15.7	18.3	18.9	19.4	19.8	20.0	20.3	20.2	
2 Change in public sector debt	-1.5	3.1	2.3	1.3	2.2	5.4	1.7	1.1	1.0	0.9	0.0	
3 Identified debt-creating flows (4+7+12)	-1.9	0.6	1.2	-0.8	4.7	5.7	2.1	1.3	1.2	1.1	0.4	
4 Primary deficit	0.0	5.5	3.5	2.5	3.7	6.2	3.7	2.5	2.1	1.9	1.6	
5 Revenue and grants	43.2	42.6	42.2	42.8	43.0	43.1	44.7	45.1	45.1	45.1	45.1	
6 Primary (noninterest) expenditure	43.3	48.1	45.7	45.3	46.7	49.3	48.4	47.6	47.2	47.0	46.7	
7 Automatic debt dynamics 3/	-1.9	-4.9	-2.1	-2.5	3.0	-0.5	-1.7	-1.2	-0.9	-0.8	-1.3	
8 Contribution from interest rate/growth differential 4/	-1.5	-2.0	-1.1	-0.6	0.2	-0.5	-1.7	-1.2	-0.9	-0.8	-1.3	
9 Of which contribution from real interest rate	0.6	-0.1	0.6	2.2	2.5	2.1	0.5	1.2	1.5	1.7	1.4	
10 Of which contribution from real GDP growth	-2.1	-1.8	-1.7	-2.8	-2.3	-2.6	-2.2	-2.4	-2.4	-2.5	-2.6	
11 Contribution from exchange rate depreciation 5/	-0.4	-2.9	-1.0	-1.8	2.8	...	...	...	...	...	...	
12 Other identified debt-creating flows	0.0	0.0	-0.2	-0.8	-2.0	0.0	0.0	0.0	0.0	0.0	0.0	
13 Privatization receipts (negative)	0.0	0.0	-0.2	-0.8	-2.0	0.0	0.0	0.0	0.0	0.0	0.0	
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2-3) 5/	0.4	2.4	1.1	2.1	-2.5	-0.3	-0.4	-0.2	-0.2	-0.2	-0.7	
Public sector debt-to-revenue ratio 2/	123.7	132.8	139.5	140.8	145.2	157.3	155.4	156.6	158.7	160.7	160.7	
Gross financing need 7/	17.2	26.8	18.8	23.3	24.4	25.9	22.1	21.7	20.1	18.8	17.8	
in billions of U.S. dollars	9.0	17.6	15.6	23.5	26.6	26.9	24.3	25.2	24.6	24.4	24.5	
Scenario with key variables at their historical averages 8/						**67.8**	**64.8**	**62.1**	**59.4**	**56.8**	**53.8**	**-1.4**
Scenario with no policy change (constant primary balance) in 2006-10						**67.8**	**72.7**	**77.2**	**81.9**	**86.7**	**90.5**	**-1.3**
Key macroeconomic and fiscal assumptions underlying baseline												
Real GDP growth (in percent)	4.3	3.8	3.4	5.2	4.1	4.5	3.5	3.7	3.7	3.8	3.9	
Average nominal interest rate on public debt (in percent) 9/	9.8	8.7	8.1	8.3	7.0	7.3	6.8	6.4	5.9	5.6	5.2	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	1.6	0.0	1.5	4.2	4.5	3.8	1.0	2.0	2.4	2.6	2.2	
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	2.0	23.9	8.3	15.3	-15.6	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	8.3	8.7	6.7	4.1	2.5	3.5	5.8	4.4	3.5	3.0	3.0	
Growth of real primary spending (deflated by GDP deflator, in percent)	5.3	15.1	-1.6	4.5	9.5	4.2	1.4	2.3	2.8	3.4	1.8	
Primary deficit	0.0	5.5	3.5	2.5	3.7	6.2	3.7	2.5	2.1	1.9	1.6	

1/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.
2/ General government gross debt.
3/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency-denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
4/ The real interest rate contribution is derived from the denominator in footnote 2 as $r - \pi(1+g)$ and the real growth contribution as -g.
5/ The exchange rate contribution is derived from the numerator in footnote 2 as $\alpha\varepsilon(1+r)$.
6/ For projections, this line includes exchange rate changes.
7/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
8/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
9/ Derived as nominal interest expenditure divided by previous period debt stock.

Table 8. Hungary: External Debt Sustainability Framework, 2001-11
(In percent of GDP, unless otherwise indicated)

		Actual					Projections						
		2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	**Debt-stabilizing noninterest current account 1/**
1	**Baseline: External debt**	64.0	55.5	62.7	67.9	75.2	**81.7**	**82.1**	**82.3**	**83.0**	**83.8**	**84.4**	**-3.5**
2	Change in external debt	0.0	-8.5	7.1	5.2	7.3	6.5	0.3	0.2	0.7	0.7	0.7	
3	Identified external debt-creating flows (4+8+9)	-5.1	-9.1	-3.1	-6.1	-3.4	2.2	2.1	1.8	1.6	1.2	1.1	
4	Current account deficit, excluding interest payments	2.8	4.5	6.4	5.9	4.5	5.9	4.6	4.0	3.6	3.1	2.8	
5	Deficit in balance of goods and services	1.4	2.3	4.5	2.9	1.2	3.4	2.5	2.5	2.1	1.6	1.3	
6	Exports	73.2	64.0	62.6	66.1	68.4	82.6	84.9	85.8	86.6	87.7	89.0	
7	Imports	74.7	66.3	67.1	69.0	69.6	86.0	87.4	88.3	88.6	89.2	90.3	
8	Net non-debt creating capital inflows (negative)	-4.7	-4.2	-1.9	-5.5	-5.8	-3.5	-3.2	-2.9	-2.8	-2.7	-2.5	
9	Automatic debt dynamics 2/	-3.3	-9.4	-7.6	-6.6	-2.0	-0.2	0.7	0.7	0.8	0.8	0.7	
10	Contribution from nominal interest rate	3.3	2.6	2.3	2.6	2.8	3.4	3.4	3.6	3.7	3.8	3.8	
11	Contribution from real GDP growth	-2.5	-1.9	-1.5	-2.7	-2.6	-3.6	-2.7	-2.9	-2.9	-3.0	-3.1	
12	Contribution from price and exchange rate changes 3/	-4.1	-10.0	-8.4	-6.5	-2.3	...	...	...	...	...	...	
13	Residual, incl. change in gross foreign assets (2-3) 4/	5.1	0.7	10.2	11.4	10.7	4.3	-1.8	-1.5	-0.9	-0.5	-0.4	
	External debt-to-exports ratio (in percent)	87.4	86.8	100.1	102.7	110.0	98.9	96.7	96.0	95.9	95.5	94.8	
	Gross external financing need (in billions of U.S. dollars) 5/	15.9	16.8	24.3	30.8	37.0	37.6	33.6	32.4	34.0	33.4	33.0	
	in percent of GDP	30.4	25.6	29.3	30.5	33.9	36.2	30.6	27.9	27.7	25.8	24.1	
	Scenario with key variables at their historical averages 6/						**81.7**	**76.6**	**71.7**	**67.4**	**63.7**	**60.1**	**-8.1**
	Key macroeconomic assumptions underlying baseline												
	Real GDP growth (in percent)	4.3	3.8	3.4	5.2	4.1	4.5	3.5	3.7	3.7	3.8	3.9	
	GDP deflator in US dollars (change in percent)	6.6	20.7	22.6	15.3	4.0	-9.0	2.2	2.0	1.9	1.9	1.9	
	Nominal external interest rate (in percent)	5.7	5.0	5.2	5.1	4.5	4.2	4.5	4.6	4.7	4.8	4.8	
	Growth of exports (US dollar terms, in percent)	10.4	9.5	24.0	28.1	12.0	14.9	8.7	6.9	6.6	7.1	7.5	
	Growth of imports (US dollar terms, in percent)	7.1	11.3	28.2	24.7	9.3	17.4	7.5	6.9	6.0	6.5	7.1	
	Current account balance, excluding interest payments	-2.8	-4.5	-6.4	-5.9	-4.5	-5.9	-4.6	-4.0	-3.6	-3.1	-2.8	
	Net non-debt creating capital inflows	4.7	4.2	1.9	5.5	5.8	3.5	3.2	2.9	2.8	2.7	2.5	

1/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels three of the last projection years.

2/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

3/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

4/ For projection, line includes the impact of price and exchange rate changes.

5/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

6/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both noninterest current account and nondebt inflows in percent of GDP.

HUNGARY: FUND RELATIONS
(As of May 31, 2006)

I. **Membership Status**: Joined on May 6, 1982; Article VIII.

II. **General Resources Account**

	SDR Million	Percent of Quota
Quota	1,038.40	100.00
Fund holdings of currency	917.15	88.32
Reserve position in Fund	121.25	11.68

III. **SDR Department**

	SDR Million	Allocation
Holdings	47.01	N/A

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements**

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-by	3/15/96	2/14/98	264.18	0.00
Stand-by	9/15/93	12/14/94	340.00	56.70
EFF	2/20/91	9/15/93	1,114.00	557.24

VI. **Projected Obligations to Fund**: None

VII. **Exchange Rate Arrangement**

The Hungarian forint trades against the euro within a band of +/- 15 percent around a central parity, which is fixed to the euro at Ft 282.36 per euro, effective June 4, 2003.

Hungary maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions, except for the exchange restrictions imposed by Hungary solely for the preservation of national or international security that have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51). Those exchange restrictions are contained in the following legal instruments:

- Council Regulation (EC) No. 2488/2000 of November 14, 2000, as amended (freezing of funds and economic resources of former Yugoslav President Slobodan Milosevic and certain other natural persons).

- Council Regulation (EC) No. 2580/2001 of December 28, 2001, as amended (freezing of funds and economic resources of certain persons, groups and entities with a view to combating terrorism).

- Council Regulation (EC) No. 881/2002 of May 29, 2002, as amended (freezing of funds and economic resources of persons and entities associated with Osama bin Laden, the Taliban and Al-Qaeda).

- Council Regulation (EC) No. 1210/2003 of July 8, 2003, as amended (freezing of funds and economic resources of certain persons and entities in respect of Iraq).

- Council Regulation (EC) No. 314/2004 of February 24, 2004, as amended (freezing of funds and economic resources in respect of Zimbabwe.

- Council Regulation (EC) No. 798/2004 of April 28, 2004, as amended (freezing of funds and economic resources in respect of Burma/Myanmar.

- Council Regulation (EC) No. 872/2004 of April 30, 2004, as amended (freezing of funds and economic resources of persons and entities associated with Liberia's former President Taylor).

- Council Regulation (EC) No. 1763/2004 of October 14, 2004, as amended (freezing of funds and economic resources of certain persons indicted by the International Criminal Tribunal for the former Yugoslavia).

- Council Regulation (EC) No. 560/2005 of April 14, 2005 (freezing of funds and economic resources of certain persons who constitute a threat to the peace and national reconciliation process in Côte d'Ivoire).

- Council Regulation (EC) No 1183/2005 of 18 July 2005, as amended, imposing certain specific restrictive measures directed against persons acting in violation of the arms embargo with regard to the Democratic Republic of the Congo.

- Council Regulation (EC) No 1184/2005 of 18 July 2005, as amended, imposing certain specific restrictive measures directed against certain persons impeding the peace process and breaking international law in the conflict in the Darfur region in Sudan.

- Council Regulation (EC) No 305/2006 of 21 February 2006, imposing specific restrictive measures against certain persons suspected of involvement in the assassination of former Lebanese Prime Minister Rafiq Hariri.

- Council Regulation (EC) No 765/2006 of 18 May 2006, concerning restrictive measures against President Lukashenko and certain officials of Belarus.

VIII. **Article IV Consultations**

Hungary is on a 12-month consultation cycle. The 2005 Article IV staff report was issued on May 20, 2005 (IMF Country Report No. 05/213). The last Article IV Board discussion took place on June 15, 2005 (EBM/05/52). The Public Information Notice No. 05/82 was released on June 29, 2005.

IX. Technical Assistance

Year	Department.	Purpose	Date
1991	FAD	Tax reform	April
1991	EU1/IMF Institute	Seminar on financial programming	May
1991	FAD	Budget reform	May
1991	FAD	Tax administration reform	June
1991	MAE/PDR	Development of a foreign exchange interbank market	September
1991	MAE/PDR	Development of a foreign exchange interbank market	October
1991	FAD	Budget reform	November
1991	FAD	Tax administration reform	November
1992	STA	Money and banking statistics seminar	March
1992	FAD	Design and implementation of a "flash" fiscal reporting system	May
1992	FAD	Revenue forecasting	June
1993	MAE/EU1/IBRD	Financial and enterprise restructuring	March
1993	MAE	Central bank reorganization	May
1994	FAD/EU1	Treasury/debt management	February
1994	FAD	Tax administration	March
1994	STA/PDR	International trade and BOP statistics	April
1994	FAD	Tax administration follow-up	May
1994	FAD	Expenditure management	June
1994	FAD	Tax administration	July
1994	FAD	Local government	August
1994	FAD	Tax administration	November
1995	FAD	Tax administration	February
1995	FAD	Treasury	February
1995	FAD	Treasury	May
1995	FAD	Treasury	November
1995	FAD	Debt management	November
1995	MAE	Central bank internal auditing	November
1995	MAE	Monetary analysis and research	December
1996	FAD	Tax policy	May
1996	MAE	Central bank accounts	September
1996	FAD	Subsidies	November
1997	FAD	Subsidies follow-up	May
2000	FAD	Tax legislation	June
2000	STA	Money and banking statistics	October
2000	FAD	Tax legislation follow-up	November
2002	FAD	Expenditure rationalization	November

X. Regional Resident Representative for Central And Eastern Europe

The regional office was opened in February 2005.

HUNGARY: STATISTICAL ISSUES

1. Data provision to the Fund is timely and facilitates effective surveillance. Significant progress has been made in improving the coverage, periodicity, and other aspects of quality related to Hungarian economic and financial statistics. Most data quality issues noted in the data module of the 2001 Report on the Observance of Standards and Codes (ROSC) have been satisfactorily addressed, but some still remain.[11]

2. Hungary subscribes to the Special Data Dissemination Standard (SDDS), and its metadata are posted on the Fund's Dissemination Standards Bulletin Board. Hungary meets the SDDS specifications for the coverage, periodicity, and timeliness of the data, and for the dissemination of advance release calendars.

Real Sector Statistics

National accounts

3. A statistical discrepancy between the final version of GDP by production activities and GDP by expenditure components emerged in 1997, and has persisted. From 2000, the Hungarian Central Statistical Office (HCSO) has been regularly publishing an estimate of this discrepancy for final annual data. Subsequent methodological refinements and a change in the base year have trimmed the magnitude of the discrepancy to about 1 percent of GDP, based on 2001 current price data, and ½ percent in 2002. From June 2002, the HCSO began publishing seasonally adjusted estimates of quarterly GDP by type of economic activity and by expenditure components beginning with the first quarter of 2002, with retrospective coverage from 1995. The benchmarking of the quarterly estimates to the annual estimates has been applied from 2000. Beginning with the annual data for 2000, the methodology for estimation of imputed owner-occupied rent, which had been based on 1993 benchmarks, was changed in line with recommendations of Eurostat. Series of quarterly GDP at constant 2000 prices extend back to 2000.

4. There have been some methodological changes in the 2001–2002 annual national accounts, with substantial progress in the transition to calculating the data on accrual basis. There was a change in the accounting method of re-export and the net base accounting was calculated for 1998 going backwards. The full set of non-financial accounts of the general government sector was compiled for the period of 2001–02. Revision of the Gross Fixed Capital Formation (GFCF) data was facilitated by further development of the data collection system, the estimation of the previously missing items of GFCF, and the application of the methodology of ESA95. All the important GFCF items were estimated by applying the same methodology for the breakdown of sectors, industries, and regions for 2000–02.

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[11] The original 2001 ROSC Data Module and its annual updates are available on the IMF internet web site. The latest update is *Hungary: Report on the Observance of Standards and Codes—Data Module, 2004 Update* (July 2004).

5. The weights of the monthly consumer price index (CPI) and the producer price index (PPI) are updated each year. The weight reference period used in for the CPI is two years prior to the current year.

External Sector Statistics

6. A work plan, with clear time tables, has been implemented to replace the cash-based balance of payments statistics, compiled by the Magyar Nemzeti Bank (MNB), with the accrual-based accounting principles of the fifth edition of IMF's Balance of Payments *Manual* (BPM5). The following improvements have been implemented: exports and imports of goods are derived from foreign trade data, which from May 2004 are based on the Intrastat/Extrastat system; and balance of payments statistics record goods under processing and repair on goods, and financial lease arrangements according to the BPM5 methodology. Moreover, in 2004, estimates of reinvested earnings were included in the balance of payments statistics, raising the current account deficit with an offsetting impact on the financial accounts. Further improvements were implemented in 2004, with the recording of investment income on an accrual basis. These modifications completed the process of shifting Hungary's balance of payments statistics to accrual-based accounting consistent with the BPM5. The release of revised quarterly series by the MNB in 2004 covered the period 1995–2003.

7. The MNB and the HCSO have reconciled their data sources and methodologies with regard to travel receipts and payments, eliminating a discrepancy which had existed in this area between the balance of payments statistics and the national accounts.

8. Since 2002, improved cooperation between the HCSO and the MNB has been formalized through memoranda of understanding signed each year between the two institutions, identifying areas to improve statistics and harmonizing data sources and methodologies.

Monetary and Financial Statistics

9. The International Financial Statistics (IFS) country page for Hungary provides timely data for the monetary authorities, banking institutions, and the banking survey. Since January 2003, the MNB has collected and compiled monetary data using the European Central Bank's (ECB) methodological framework. Accordingly, the monetary financial institutions sector now includes money market funds (MMFs); credit is classified on a gross basis; fixed assets are classified at acquisition cost; deposits at face value (without interest accrued); and zero coupon bonds recorded at their discounted values.

10. An area where the monetary statistics is not fully in line with international standards is in the valuation of securities. Presently, the securities on the balance sheets of depository corporations are not always valued at market prices. Progress, however, has been made. Since 2004, the MNB has encouraged depository corporations to use market valuation for securities in their trading portfolio. In 2005, the MNB made market valuation compulsory for depository corporations that are listed on the stock exchange. In addition, the securities of all

companies that are listed on the stock exchange and held by depository corporations in their trading portfolio must be market valued.[12] Depository corporations are required to revalue their securities at least quarterly, and more frequently if possible. At present 12 banks (out of 40) apply market valuation for securities in their portfolios.

11. The ROSC mission of 2001 also noted that the MNB's statistical practices are not guided by revisions studies. In September 2001, a study was prepared with the aim of summarizing the revision practice of the monetary statistical publications. The main elements are as follows. New monetary accounts and interest rate data which are first published according to the advance release calendar can be considered preliminary, because cross-checks with other statistics (e.g. BOP stocks) are made in the course of the next month. Corrections can be performed due to on-site and off-site controls of the reports as well (focusing on time series of given reports or on the cross checking of various reports relating to a given date of reporting institutions). Publication of the necessary revisions is performed on the next publication dates together with the newest data. Revisions of the publications may take place due to methodological changes as well, which are generally made public in advance and go back as many years in the time series as possible. In doing so, estimations are also applied.

Government Finance Statistics (GFS)

12. In January 2004, STA conducted a substantive update of the GFS dataset using the July 2003 Data Quality Assessment Framework. The mission reported that, overall, significant progress has been made in addressing the shortcomings of budget execution data and GFS identified in the original ROSC Data Module. These improvements relate mainly to institutional coverage of general government, consolidation of data and reconciliation of deficit and financing. However, plans to report monthly expenditures classified on an economic basis have yet to come to fruition.

13. The latest data reported for publication in the *2005 GFS Yearbook refer to* 2003. These data now cover the operations of the consolidated central government and consolidated general government sectors, as well as their corresponding subsectors. The data for 2000 onwards have been compiled on an accrual basis and reported in the Government Finance Statistics Manual 2001 format.

[12] The securities of companies not listed on the stock exchange will be priced on the basis of secondary market values. In the absence of a secondary market, the valuation will reflect: (i) company profitability using the last two annual company reports, or (ii) the present value of securities. If no other information is available, the acquisition price is used.

HUNGARY: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
AS OF JULY 7, 2005

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]	Memo Items:	
						Data Quality – Methodological soundness[7]	Data Quality Accuracy and reliability[8]
Exchange Rates	5/31/06	6/7/06	D and M	D and M	D and M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	May 2006	6/21/06	M	M	M		
Reserve/Base Money	Mar 2005	4/8/05	M	M	M	O,O,LO,LO	O,O,O,O,LO
Broad Money	Apr 2006	6/15/06	M	M	M		
Central Bank Balance Sheet	Apr 2006	6/15/06	M	M	M		
Consolidated Balance Sheet of the Banking System	Apr 2006	6/15/06	M	M	M		
Interest Rates[2]	May 2006	6/15/06	M	M	M		
Consumer Price Index	May 2006	6/20/06	M	M	M	O,O,O,O	O,O,O,O,NA
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2003	7/13/04	A	A	A	O,LNO,LO,O	LO,O,O,O,NA
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Mar 2005	4/29/05	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q1 2005	4/29/05	Q	Q	Q		
External Current Account Balance	Q4 2005	4/14/06	Q	Q	Q	O,LO,LO,LO	O,O,O,O,NA
Exports and Imports of Goods and Services	Q4 2005	4/14/06	Q	Q	Q		
GDP/GNP	Q4 2005	3/10/06	Q	Q	Q	O,O,O,LO	O,LO,O,O,NA
Gross External Debt	Q4 2004	3/31/05	Q	Q	Q		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA).
[7] Reflects the assessment provided in the data ROSC and Substantive Update published in May 2001 and July 2004, respectively, and based on the findings of the respective missions that took place during January 2001 and January 2004 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).
[8] Same as footnote 7, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

INTERNATIONAL MONETARY FUND

HUNGARY

Staff Report for the 2006 Article IV Consultation
Supplementary Information

Prepared by the European Department

Approved by Susan Schadler and Adnan Mazarei

October 4, 2006

1. This supplement reviews developments since the issuance of the 2006 Article IV consultation staff report and provides a brief staff assessment. It also updates the PIN. The thrust of the staff appraisal remains unchanged. The authorities' Convergence Programme (CP) submitted to the European Commission (EC) on September 1 sets out a slower but more realistic consolidation path than envisaged in June and reported in the staff report.[1] Financial markets have cautiously endorsed the resolve to reduce the fiscal deficit, which will also lower the current account deficit. Nevertheless, the task of mitigating short-term risks and achieving long-term fiscal sustainability has just begun and continued resolve will be needed in implementing durable structural reforms. With the economy weakening earlier than anticipated, staff's call for caution on the speed of monetary tightening is reinforced.

IV. Political Developments

2. **The recent political disturbances have served as a wake-up call on the need for greater transparency.** Street demonstrations followed the leakage of Prime Minister Gyurcsány's speech, in which he acknowledged that the government had concealed the seriousness of the fiscal situation prior to the April parliamentary elections. The Prime Minister, however, retained the strong support of his party and coalition, and reiterated the need for dealing with the critical fiscal challenges. Markets remained calm and asset prices moved in a small range. In the October 1 municipal elections, the government's popular support eroded and the opposition party, Fidesz, made strong gains. However, the governing coalition held on to the Budapest mayoral position, and with its safe majority in parliament, the government should be in a position to win the upcoming vote of confidence and pursue the goals articulated in the CP.

[1] On September 26, the EC endorsed the CP, highlighting continuing risks and calling for strict implementation. The Council of Economics and Finance Ministers of the European Union will make its decision on October 10.

V. IMPLICATIONS OF RECENT DEVELOPMENTS FOR THE OUTLOOK

3. **Recognizing the significant actions taken, staff has lowered its projections for the fiscal deficits.** The required tax legislation has been passed and the higher rates are in effect. Steps have been taken to reduce central government employment, freeze public wages, lower energy price subsidies, and implement measures in healthcare and education. With these in place, along with some budgetary control measures, staff estimates the fiscal deficit will decline from 10.7 percent of GDP in 2006 to 7.9 percent of GDP in 2007, and further to 5.6 percent of GDP in 2008 (Text Table 1 and Table 1).[2] On this basis, staff now projects additional consolidation of 0.6 and 0.9 percent of GDP in 2007 and 2008, respectively, relative to the staff report. At the same time, the authorities have raised their deficit projections, which now present a more realistic assessment of the likely fiscal consolidation path (Table 2). The continuing differences in deficit projections—of 0.6 percent of GDP in 2006 and about 1 percent of GDP a year thereafter—reflect staff's caution in light of the uncertainties associated with implementation. Both the staff and authorities' estimates point to a rising debt ratio through 2008, when it is expected to peak at about 73 percent of GDP. However, in staff's central scenario, the debt ratio's decline in the outer years would be noticeably less than that projected by the authorities. Important pension and social welfare reforms, as well as steps to broaden the tax base, have yet to be detailed and remain crucial for more rapid and durable deficit and debt reduction.

Text Table 1. Hungary: Comparison of Staff Report and Current Projections, 2006-10

		2006	2007	2008	2009	2010
Real GDP growth (in percent)	Staff Report	4.5	3.5	3.7	3.7	3.8
	Current	3.6	2.8	3.4	3.7	3.8
Inflation (average, in percent)	Staff Report	3.5	5.8	4.4	3.5	3.0
	Current	3.6	6.1	3.8	3.3	3.0
	In percent of GDP					
External current account balance	Staff Report	-9.1	-8.0	-7.6	-7.4	-7.1
	Current	-8.6	-7.2	-6.2	-5.4	-5.0
General government balance 1/	Staff Report (excl. PPPs)	-10.1	-7.6	-6.4	-5.8	-5.5
	Staff Report (incl. PPPs)	-10.7	-8.5	-6.5	-5.8	-5.5
	Current (incl. PPPs)	-10.7	-7.9	-5.6	-4.2	-3.7
Gross external debt 2/	Staff Report	81.8	82.2	82.5	83.2	84.0
	Current	82.8	82.5	82.6	82.5	82.2
General government debt 2/	Staff Report	67.2	68.9	70.1	71.1	72.0
	Current	70.1	72.9	73.6	73.2	72.4

Source: Staff estimates.

1/ Deficit numbers now include the budget of motorway construction-related expenditures, a practice adopted by the authorities in their September 2006 Convergence Programme.

2/ The higher 2006 debt figures reflects revisions to the end-2005 debt ratio and valuation effects.

[2] These deficit numbers include for the first time the budget of motorway construction-related expenditures, a practice adopted by the authorities in their September CP (as recommended by recent staff reports and the fiscal ROSC). These expenditures amount to 0.6, 0.9, and 0.1 percent of GDP through 2006 to 2008.

4. **Financial markets continued to differentiate Hungary through the summer but have since cautiously reduced this differentiation.** Calmer international markets, which saw the Icelandic krona and the Turkish lira regaining part of their sharp losses, also benefited the forint, though with a lag. Markets appear to be viewing the prospects of consolidation favorably, as indicated by the mild reaction to the recent demonstrations. The forint has traded in a very narrow range and yields on local currency bonds have increased by about 25 basis points. The rating agencies, however, have taken a more cautious view of the political disturbances. Fitch changed its outlook from stable to negative (within the rating category BBB+) on September 20 and Moody's placed Hungary on review for a possible downgrade on September 25. These actions had limited impact.

5. **Reflecting an earlier than anticipated slowdown, staff has lowered its projection of GDP growth and current account deficit estimates.** A slowdown in the second quarter (going against the trend of accelerating growth elsewhere in the region) reflected a pullback in publicly-sponsored motorway investment and a fall in corporate and residential investment. Import growth, which tends to be a forward-looking indicator, also decelerated. Since the announcement of the fiscal consolidation package in June, retail sales have been weaker than expected and indices of consumer and business confidence have been falling. The anticipated higher personal income taxes and public sector lay offs and the wage freeze may have begun to restrain spending earlier than had been projected. Accordingly, staff's GDP growth projection has been revised down from 4.5 to 3.6 percent for 2006 and from 3.5 to 2.8 percent for 2007.[3] As a consequence, import growth is also expect to slow, and the current account deficit projected for 2007 is now 7.2 percent of GDP, 0.8 percent of GDP lower than in the staff report. The trajectory of lower expected current account deficits over the next few years will reduce the pace of external debt accumulation.

6. **Inflation is expected to recede close to the target range over the medium term.** Inflation has risen modestly since the staff report was issued. While inflation is expected to increase further in the next twelve months due to tax and administered price increases, the slowing economy should keep inflation contained. The authorities and the staff have revised upwards their inflation projections for 2006 and 2007. Staff is now expecting inflation at 3.6 percent in 2006 and 6.1 percent in 2007, when the one-time effects of the tax and administered price increases will kick in. Reflecting the expected slowdown in growth, staff projects inflation to fall to 3.8 percent in 2008, just inside the ±1 percent range around the 3 percent inflation target, while the Magyar Nemzeti Bank (MNB) is forecasting a slightly higher 4.2 percent inflation rate. The MNB has raised the policy rate by a cumulative 175 basis points in four steps since June. With the projected 2008 inflation rate either within

[3] The authorities' growth estimates have not yet incorporated the recent deceleration. Their growth projections and that of staff are broadly similar—slower growth in 2007 and 2008 relative to 2006 and a rise thereafter.

or just outside the target band, staff continues to recommend measured tightening that responds to second-round effects if they do emerge, or a pause if these inflationary effects are mitigated by the recent growth deceleration and the expected fiscally-induced slowdown.

VI. Staff Assessment

7. **The CP marks a significant step forward towards needed fiscal consolidation, but, if this objective is to be durably achieved, firm implementation of structural reforms and a high level of transparency remain essential.** The CP has been successful in alleviating short-term vulnerabilities. Risks, however, are inherent to the strategy of relying initially on tax increases on personal and corporate incomes and on one-off measures such as wage freezes. First, the tax hikes could produce less revenue than anticipated due to evasion or slower than projected growth. Second, the 2009 budget will need to address the pressure to raise the frozen public sector wages. Also, the high tax wedge cannot be sustained. If the more durable measures (of the type emphasized in the staff report) are not in place by then, the financial turbulence of this spring and summer may repeat. Even if everything goes as planned, the deficit will still be sizable (3½-4 percent of GDP) in 2009, government expenditure (45 percent of GDP) disproportionate to Hungary’s per capita income, the tax wedge high, and the public debt-to-GDP ratio above 70 percent. These features could cause a prolonged period of below-potential economic performance. Finally, though the government successfully navigated the recent political disturbances, transparent communication of the risks and sacrifices that lie ahead will prevent more disruptive reactions in the future.

8. **Policy interest rates should remain focused on achieving the inflation target 18 to 24 months ahead.** Short-term inflation tendencies are currently characterized by considerable uncertainty in view of the many changes to taxes and subsidies. Thus, it is difficult to infer inflationary trends from the recent rise in inflation. Both the authorities and staff see inflation declining to close to or within the target range by 2008 and, hence, over the horizon relevant for monetary policy decisions. The recent increases in policy interest rates appear to have been at the higher end of the range of interest rate hikes needed under current circumstances to bring inflation two years out within the target range. Staff urges continued communication that the interest rate policy will be guided by the inflation target (and not by an exchange rate target) and that further rate increases will respond to the strength of second-round effects from the tax and subsidy changes.

Table 1. Hungary: Staff's Illustrative Medium-Term Scenario, 2002-10

	2002	2003	2004	2005	2006	2007	2008	2009	2010
					Staff projections				
	(In percent, unless otherwise indicated)								
Real GDP growth	3.8	3.4	5.2	4.1	3.6	2.8	3.4	3.7	3.8
Nominal GDP, forint billions	16,915	18,651	20,429	21,802	23,418	25,553	27,435	29,374	31,405
Inflation (CPI; year average basis)	5.3	4.6	6.8	3.6	3.6	6.1	3.8	3.3	3.0
Inflation (CPI; end-year basis)	4.8	5.7	5.5	3.3	6.3	5.5	3.5	3.0	3.0
	(Annual percentage change, constant prices)								
Domestic demand	5.9	6.0	4.1	0.8	2.6	0.6	2.5	3.6	4.1
Consumption	9.4	7.7	3.2	1.1	2.9	-0.3	1.5	2.7	3.3
Gross fixed capital formation	10.2	2.9	8.0	6.6	4.4	4.1	5.5	5.8	5.8
Exports of GNFS	3.9	6.1	15.8	10.8	13.3	7.5	7.1	6.4	6.5
Imports of GNFS	6.6	9.3	13.5	6.5	11.9	5.3	6.3	6.3	6.8
	(In percent of GDP)								
External current account balance	-7.1	-8.7	-8.6	-7.4	-8.6	-7.2	-6.2	-5.4	-5.0
Gross national saving	18.0	15.8	16.8	16.3	16.9	19.1	20.6	21.8	22.6
Gross national investment 1/	25.0	24.4	25.4	23.7	25.5	26.4	26.8	27.2	27.5
Gross external debt 1/	55.5	62.7	67.9	75.6	82.8	82.5	82.6	82.5	82.2
Private sector savings-investment balance 3/	-1.6	-1.9	-2.1	0.1	2.1	0.6	-0.6	-1.2	-1.3
Gross private savings	20.0	17.8	20.0	20.4	22.9	22.3	22.1	22.0	22.3
Gross private investment	21.6	19.7	22.1	20.4	20.8	21.7	22.7	23.2	23.5
General government (ESA-95)									
Revenue, primary	42.6	42.2	42.8	43.0	43.1	44.6	45.0	45.8	45.5
Expenditure, primary	48.0	45.7	45.2	46.6	49.8	48.2	46.6	46.1	45.4
Primary balance	-5.4	-3.5	-2.5	-3.6	-6.7	-3.6	-1.7	-0.4	0.0
General government balance (including the costs of pension reform) 4/	-9.1	-7.3	-6.5	-7.5	-10.7	-7.9	-5.6	-4.2	-3.7
General government balance (excluding the costs of pension reform) 4/ 5/	-8.4	-6.4	-5.4	-6.2	-9.3	...	...	...	...
Net interest	3.7	3.8	4.0	3.9	4.0	4.3	4.0	3.9	3.8
General government debt	56.6	58.9	60.2	62.4	70.1	72.9	73.6	73.2	72.4
General government debt (excluding the costs of pension reform) 5/	55.0	56.7	57.1	58.4	64.0	...	...	...	...
Memorandum items									
Output gap	-0.4	-0.9	-0.3	-0.2	-0.6	-1.9	-2.6	-3.0	-3.3
Structural general government balance	-9.0	-7.0	-6.4	-7.4	-10.5	-7.3	-4.8	-3.3	-2.7
Structural primary balance	-5.3	-3.2	-2.4	-3.6	-6.5	-3.0	-0.9	0.6	1.1

Sources: Hungarian authorities; and staff estimates.

1/ Includes change in inventories.
2/ Includes intercompany loans.
3/ Consistent with the balance of payments data (not necessarily with the national accounts data).
4/ The 2002 general government balance includes various one-off financial operations (amounting to 3.1 percent of GDP) that are not part of the saving-investment balance on a national accounts basis.
5/ The exclusion of the costs of the pension reform is as indicated under the revised Growth and Stability Pact.

Table 2. Hungary: September 2006 Convergence Programme Projections, 2006-11

	2006	2007	2008	2009	2010	2011
Real GDP growth (in percent)	4.1	2.2	2.6	4.1	4.2-4.5	4.5
Inflation (CPI: year average basis, in percent)	3.5	6.2	3.3	3.0	2.5-3.0	2.5-3.0
			In percent of GDP			
External current account balance	-7.9	-5.9	-4.4	-3.6	-3.0	-2.0
General government balance	-10.1	-6.8	-4.3	-3.2	-2.7	-2.2
General government primary balance	-6.3	-2.4	-0.2	0.8	1.0	1.5
General government debt	68.5	71.3	72.3	70.4	68-69	65-67

Source: Ministry of Finance.

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2006 Article IV Consultation with Hungary

On October 11, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Hungary.[1]

Background

Economic performance was respectable in 2005, though with mixed signals. GDP growth slowed to 4.1 percent in 2005, the lower end of the economy's potential estimated at between 4 and 5 percent a year. Consumption moderated, while investment and exports were sources of strength. Fixed investment growth reflected largely government-sponsored motorway construction. While business profitability was maintained overall, about two-fifths of small-and medium-sized enterprises were reported to be unprofitable. Inflation declined significantly, helped by globalization and one-off domestic factors.

Despite the relatively good macroeconomic performance, a loss of fiscal discipline has created a twin deficit problem and worrisome debt dynamics. The series of missed fiscal deficit targets continued in 2005, with the deficit reaching 7.5 percent of GDP, compared with a budgeted deficit of 4.7 percent of GDP. The current account deficit remained high, at 7.4 percent of GDP. Reflecting these developments, fiscal and external debt levels have risen to worrisome levels over the last few years. The continuing sharp increase in foreign currency lending to small businesses and households has created a further source of vulnerability. The risks were, however, somewhat mitigated by the presence of buffers. The reserves-to-short-term debt ratio remained above 100 percent, and public debt had long maturities and low foreign

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

currency exposure, minimizing the government's rollover risk and the costs of a large depreciation.

The vulnerabilities caused financial markets to differentiate Hungary from the rest of the region. The differentiation of the forint started in late 2005 and increased thereafter, as did its volatility. Yields on local currency bonds increased along with spreads on foreign currency credit default swaps. Two major rating agencies downgraded Hungary and the third has put its rating on review, pointing to persistent twin deficits and rising debt ratios, while the ratings of other new member states of the EU have either remained unchanged or have been raised. However, financial markets have been calmed by the fiscal consolidation package laid out in the Convergence Programme submitted by the authorities to the European Commission on September 1, and market reaction to recent political disturbances has been relatively mild.

Executive Board Assessment

Executive Directors noted that Hungary has benefited greatly over the past decade from significant economic reforms, and commended the performance of Hungary's private sector and its resilience despite macroeconomic uncertainties. Directors noted, however, that the persistently large fiscal deficits and weak budget execution of recent years have led to unsustainable increases in public debt, and economic growth, while respectable, has lagged behind the performance of the New Member States of the European Union. While inflation has fallen to historic lows, vulnerabilities relating to large fiscal and current account deficits have weakened the forint and local currency bond prices. Against this background, Directors stressed that urgent actions are needed to restore policy credibility and redress the fiscal and current account balances in order to strengthen the groundwork for sustained high growth.

Directors welcomed the authorities' EU Convergence Programme and the associated multi-year fiscal consolidation package, which they viewed as a significant effort to address Hungary's difficult challenges. They underscored that steadfast implementation of the proposed adjustment will be crucial, along with the authorities' readiness to take any additional measures that may be required to signal to markets and partners the authorities' strong commitment to achieving Hungary's goal of rapid nominal and real convergence. Equally, continued resolve will be needed in carrying forward structural reforms to strengthen budgetary processes and increase the flexibility and competitiveness of the economy.

Directors emphasized that the principal policy task is to place public finances on a sound footing. They were encouraged by the significant steps reported in the authorities' Convergence Programme, which they felt is based on a realistic reassessment of the fiscal challenges facing Hungary. The expected fiscal consolidation would lower the current account deficit and alleviate short-term vulnerabilities. Directors noted, however, that reaching the targets in the program would require detailing further measures. Moreover, they emphasized that a fiscal consolidation that is sustained over a longer period will be needed to lower progressively the public debt-to-GDP ratio to a safer level. Directors urged the authorities to implement a medium-term budget framework with multi-year expenditure ceilings to guide fiscal policy.

Directors stressed that the composition of fiscal adjustment will have an important influence in shaping the medium-term economic outlook going forward. Hungary will benefit from greater reliance on expenditure-based consolidation that can enhance growth and efficiency, while avoiding the growth dampening effects of undue reliance on revenue measures. In this context, Directors welcomed the expenditure reduction measures in the Convergence Programme. They urged more forceful reforms of pensions and social welfare transfers, while noting that improved targeting and efficiency will contribute to lasting consolidation. Directors stressed the continuing importance of containing overruns in the budget deficit through greater transparency and accountability, and in this context supported recent efforts to institute budgetary controls. Strengthening budgetary management was seen as a priority to engender confidence that the envisaged fiscal consolidation will be successfully implemented. Directors considered that any gains in revenues would best be achieved through broadening the tax base, including by instituting a more far-reaching property tax, rather than through surcharges on already high taxes on capital and labor.

Directors commended the National Bank of Hungary for its success in establishing the inflation targeting regime, highlighting the important role played by timely communication of policy actions. Directors considered that a measured monetary policy tightening may be needed in the event of price increases in the coming months due to recent tax hikes and subsidy reductions. However, given the one-off nature of the envisaged pressures and with a weakening economy, inflation is expected to fall back close to the target in 2008. The challenge, Directors observed, is to identify one-off inflationary influences, communicate them to the public and financial markets, and fine-tune interest rate policy to deal with second-round effects.

While acknowledging the robustness of the banking sector, including its profitability and capitalization, Directors highlighted the increasing risks stemming from the rapid growth in foreign currency lending. They noted that those risks are amplified by recent aggressive lending practices and financial fragility of small and medium-sized enterprises. Directors emphasized the need for more proactive supervision and regulation, including by instituting regular stress tests of individual banks and more intensive on-site supervision of banks' risk management practices.

Directors had a wide-ranging discussion of the view that a floating exchange rate regime may be best suited to Hungary's circumstances. A number of Directors considered that a floating exchange rate regime would be appropriate from a risk-management perspective and would strengthen the inflation-targeting anchor. They also felt that increasing the perception of greater exchange rate variability could reduce incentives to borrow in foreign currency. Some other Directors, however, noted that the fluctuation band already provides adequate room for maneuver in the conduct of inflation targeting. In any event, it was recognized that timing issues will be crucial, and many Directors expressed concern that a formal switch in the exchange rate regime in present circumstances could send a mixed signal to markets.

Directors stressed the need for actions to enhance labor market performance and competitiveness. Raising employment will require reducing the overall cost of labor and better targeting social welfare programs. Directors emphasized that productivity enhancement will be crucial for maintaining competitiveness. In this context, they encouraged the authorities to improve the pace of absorption of EU funds in productivity-enhancing activities, while linking their deployment to fiscal structural reforms.

Hungary: Selected Economic Indicators

	2002	2003	2004	2005	2006 Proj.
Real economy (change in percent)					
Real GDP	3.8	3.4	5.2	4.1	3.6
CPI (average)	5.3	4.7	6.8	3.6	3.6
Unemployment rate (in percent)	5.8	5.9	6.1	7.2	7.4
Wage Growth (gross wages)	18.2	12.9	6.1	7.8	…
Gross national saving (in percent of GDP, from BOP)	18.0	15.8	16.8	16.3	16.9
Gross domestic investment (in percent of GDP) 1/	25.0	24.4	25.4	23.7	25.5
General government (percent of GDP), ESA-95 basis 2/					
Balance	-9.1	-7.3	-6.5	-7.5	-10.7
Debt	56.6	58.9	60.2	62.4	70.1
Money and credit (end-of-period, percent change)					
M3	9.3	12.0	11.6	14.6	…
Credit to nongovernment	21.9	34.4	19.2	18.8	…
Interest rates (percent)					
T-bill (90-day, average)	8.9	8.2	11.1	6.8	…
Government bond yield (5-year average)	7.8	7.3	9.2	6.8	…
Balance of payments					
Trade balance (percent of GDP) 3/	-3.2	-3.9	-3.0	-1.8	-2.8
Current account (percent of GDP) 3/	-7.1	-8.7	-8.6	-7.4	-8.6
Reserves (in billions of US dollars)	10.4	12.8	16.0	18.6	19.5
Net external debt (percent of GDP) 4/	23.3	29.1	32.7	34.7	40.4
Exchange rate					
Exchange regime	Peg against euro, with band +/-15 percent				
Present rate (September 30, 2006)	Ft 215.74 = US$1				
Nominal effective rate (1990=100)	38.9	38.8	39.6	39.2	…
Real effective rate, CPI basis (1990=100)	166.2	170.1	181.3	182.8	…

Sources: Hungarian authorities; IMF, *International Financial Statistics*; Bloomberg; and staff estimates.

1/ Includes change in inventories.

2/ Consists of the central budget, social security funds, extrabudgetary funds, and local government. Includes the costs of pension reform.

3/ The central bank believes that due to methodological changes, 2005 imports may be understated by up to 2 percentage points of GDP.

4/ Including intercompany loans, and nonresident holdings of forint-denominated assets.